

Bringing Islamic Banking into the Mainstream is not an Alternative to Conventional Finance

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Abstract

The latest economic crisis shook the previously firm belief in the prosperity-bringing financial sector around the globe. For many months after the catalytic bankruptcy of Lehman Brothers, the economy was in apparent freefall. News about plunging equity, housing, and commodity markets, dried out inter-bank lending, nose-diving industrial production and trade, and rising unemployment have characterized our daily routine. But between all this doom and gloom some parts of the deeply shaken financial sector attempted to promote themselves as bearers of hope for a new, improved, and more stable financial system. Economists, politicians, and clergymen alike increased their efforts during the financial crisis to make the mainstream aware of the advantages of Islamic finance. Islamic financial assets today are believed to barely exceed U.S.\$1 trillion, but have been observed to grow in the two-digit area over the last decade [Economist (2008)]. Hence, Islamic finance has its foot in the door of the financial mainstream. The mentioned economists, politicians, and

clergymen are helping with the last push to open this door. But what will happen once Islamic finance tumbles into the mainstream? Will we enter an era of new, religion-like belief in stable and prosperity-bringing finance? The announcement in late 2009 by Dubai World, the emirate's flagship for investment in the region, that it was not able to repay an Islamic bond in time cast fresh doubts on Islamic finance's claim of inherent stability. This article argues that Islamic finance is not a stable alternative, since Islamic banking in particular and Islamic finance in general do not differ significantly from conventional banking and finance. In the following the reasons for the alleged superiority of Islamic finance will be explored, namely its developmental character, the inherent stability, and the importance it assigns to individuals' morality. Being based on Islamic economics, Islamic finance simply replaces the religion-like belief in the neoclassical dogma of the efficient market with the religiously motivated belief in the morality of the homo Islamicus. The outcome is strikingly similar.

The latest economic crisis shook the previously firm belief in the prosperity-bringing financial sector around the globe. While investment banks like Lehman Brothers could pick among the brightest and best performing university graduates swamping their doors, in the post-Lehman world, laid-off bankers and traders knock at the doors of universities trying to bridge their unemployment, exploring the reasons for financial instability. For many months after the catalytic bankruptcy of Lehman Brothers, the economy was in apparent freefall. News about plunging equity, housing, and commodity markets, dried out inter-bank lending, nose-diving industrial production and trade, and rising unemployment have characterized our daily routine. But between all this doom and gloom some parts of the deeply shaken financial sector attempted to promote themselves as bearers of hope for a new, improved, and more stable financial system. Economists, politicians, and clergymen alike increased their efforts during the financial crisis to make the mainstream aware of the advantages of Islamic finance.

Politicians like Malaysia's Prime Minister Ahmad Badawi declared Islamic finance a stable alternative, attempting to establish their country as a global Islamic finance center. Western economists such as Presley and Ferro together with Islamic ones like Chapra and Saddiqi pointed toward the developmental nature of Islamic finance [Dar and John (1999), Ferro (2005), Chapra (2000), Siddiqi (1983, 2000)]. Clergymen – most recently the Pope – joined in praising its ethical character [Wigglesworth (2009)].

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The announcement in late 2009 by Dubai World, the emirate's flagship for investment in the region, that it was not able to repay an Islamic bond in time cast fresh doubts on Islamic finance's claim of inherent stability. This article argues that Islamic finance is not a stable alternative, since Islamic banking in particular and Islamic finance in general do not differ significantly from conventional banking and finance. Islamic banking being the oldest and most visible element of Islamic finance is to some extent understood as *pars pro toto* – i.e., representative for the Islamic finance industry as a whole. In the following, the reasons for the alleged superiority of Islamic finance will be explored, namely its developmental character, the inherent stability and, the importance it assigns to individuals' morality.

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Why is Islamic banking superior to conventional banking?

1. ... because Islamic finance is more developmental than conventional finance

Islamic economics emphasizes the need for the economic and financial system to promote social welfare. Economic stability is one of the goals of Islamic economics and concurrently its means to generate welfare since stability is regarded as conducive to growth and development [Chapra (2000)]. The claim of a developmental character to Islamic finance is often backed with empirical observations from microfinance institutions [Ferro (2005)]. One of the biggest and most well-known amongst these institutions, Grameen Bank, is based in Bangladesh and therefore caters to a Muslim clientele. Islamic lending is often perceived to be character-based just like micro loans [Dhumale and Sapcanin (2004)], which frequently depend on tightly knit local community structures for enforcement.

Additionally, standard economic theory can be drawn upon to show that Islamic banking achieves a Pareto-optimal credit allocation while conventional finance in comparison fails to do so. In other words, the credit allocation under an Islamic contract improves the situation for at least one participant (creditor or borrower) in comparison to conventional lending, without worsening it for anyone else. Arguably, under an Islamic lending regime more credit would be available.

Mainstream (Western) economic models assume that lender and borrower possess conflicting interests. This is the reason why interest payments and collateral requirements are in place. This conflict is increasing with the amount of credit granted. While the lender has an interest in maximizing the investment effort and a full payback of his loan with interest, the borrower is believed to have an incentive in shirking and at the extreme in disappearing with the lent amount. The situation can be further complicated through informational asymmetries; i.e., lenders are uninformed about borrowers' usage of the borrowed money. This conflict of interest is precisely the reason for a premium on external finance. In a perfect world,¹ the cost of external finance would be equal to the cost of internal finance,² meaning that it would not make a difference whether firms' investment is financed by credit or by retained profits. Consequently, according to economic theory a loan which merely amounts to the borrower's net worth (W), in other words to the net worth of his collateral, should be extended at the risk-free interest rate ρ . Interest on loans beyond the

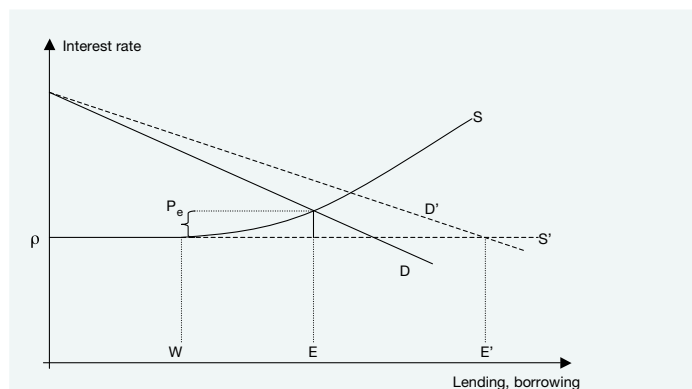
1 This is obviously the Arrow-Debreu world, where all agents possess perfect information about the past, present, and the future.

2 This is, in a nutshell, the content of the Modigliani-Miller theorem.

borrower's net worth will rise with the increase in the sum credited (Figure 1). One of the most prominent features of Islamic banking is the prohibition of interest payments and collateral requirements.

Islamic scholars believe that individuals that share the same values will not behave like the "homo economicus" in the imperfect information scenario. The "homo economicus" takes the money and runs while the "homo Islamicus" perceives this as immoral. Also, the "homo Islamicus" regards charging or receiving interest as immoral. Islamic credit contracts should, therefore, be fundamentally structured like joint venture agreements – namely profit-and-loss sharing (PLS) agreements – with varying voting and co-determination rights [Chapra (2000)]. This last proposition tries to establish the Pareto-optimal result, where borrowing and lending is undertaken at the risk-free interest rate without an external financing premium (E' in Figure 1). Theoretically, Islamic credit should be cheaper and extended to a wider range of clients because of the fact that neither interest is charged nor collateral demanded.

In practice the vast majority of Islamic loan contracts across a wide range of countries seem to use very debt-like instruments, namely mark-up pricing [Aggarwal and Yousef (1996), Chong and Liu (2009)]. Here, it is not outright interest that is charged but a fixed mark-up. Taking Malaysia as example, it can be shown that hardly any loans are given on the basis of profit-and-loss sharing which entails a joint venture-like agreement (Table 1). Furthermore, in Malaysia floating mark-ups have been allowed for Islamic mortgages since 2004 in order to make Islamic banking more competitive vis-à-vis conventional banking [Endut and Hua (2009)]. Floating mark-ups are effectively interest rates since they adapt to the central bank's policy rate. This means the borrower cannot be certain about the amount he has to pay back for the principle sum he borrowed



Source: Gertler et al. (1994).

In a perfect world, credit extension would amount to E' , catering to demand (D') at the risk-free interest rate ρ . However, since external finance is subject to a misalignment in interest between borrower and lender, there is a premium (P_e) on it as compared to internal finance and credit extension shrinks to E .

Figure 1 – The Pareto-optimality of Islamic lending

Year	2001	2002	2003	2004	2005
Primary modes of finance (Mudharabah & Musyarakah)	1.40%	0.70%	0.50%	0.50%	0.30%
Debt-like financing odes (Bai' Bithaman Ajil, Ijarah, Ijarah Thumma Al-Bai', Istisna', Murabahah, and other Islamic concepts)	98.60%	99.30%	99.50%	99.50%	99.70%

Source: BNM, Annual Reports, 2001-2005

Table 1 – Types of lending contract in Malaysian Islamic banking

initially. Establishing this kind of certainty is the main rationale behind the prohibition of interest in Islamic banking. The Malaysian example cannot be disregarded arguing that it is the exception rather than the rule. The country constitutes the biggest Islamic banking market in the world [World Bank (2006)]. But more importantly, it possesses a dual banking sector – where conventional and Islamic finance interact – and, therefore, serves as paradigm for the future development of Islamic finance once it enters mainstream finance internationally [Karwowski (2009)].

Two-thirds of all Islamic credit in Malaysia is consumption credit [BNM (2007)]. Since this kind of credit is used to purchase goods which only go over into the possession of the borrower once the full credit amount is paid off, effectively there is collateral involved. Hence, from a pragmatic point of view Islamic banking does use the two instruments, which it claims to forbid, namely interest and collateral. Consequently, it is doubtful whether Islamic banking is a Pareto-optimal allocation of credit increasing the credit volume relative to conventional banking.

2. ... because Islamic finance is more stable than conventional finance

Islamic scholars believe that the Islamic financial system is inherently more stable than the conventional one. This claim to stability is grounded on the prohibitions and requirements formulated in the Qu'ran and the body of Islamic (written and unwritten) religious law, the sharia.

The concept of profit-and-loss sharing between Islamic banks and their customers makes Islamic banks theoretically more resilient to external shocks since losses can be passed on to depositors to some extent. This would enable Islamic banks to engage in more long-term lending with higher risk-return profiles typical for growth promoting investments such as infrastructure. However, as pointed out previously, in practice PLS is marginalized in Islamic lending in favor of mark-up pricing which often serves for short-term consumption instead of long-term investment.

Apart from the absence of interest and collateral in credit agreements, Islamic finance prohibits speculation (gharar), which is maybe most apparently linked to financial stability. This prohibition reflects a general distrust

against transactions that are not asset-backed. However, as we are experiencing in the current crisis, financial instruments backed by assets such as residential building or company value – namely mortgage-based securities and private equity – can destabilize the entire economic system profoundly. If substantive liquidity flows into the equity market, the fact that only a limited amount of shares exists causes a sharp increase in the price of equity traded in the secondary market. Rising price in turn attracts even further inflows of liquid funds into a market on the grounds of expected further price appreciation [Toporowski (2000)]. This kind of capital market inflation increasingly gaining momentum with financial liberalization, widening profit yields, and profit opportunities of financial instruments create financial instability. A financial system that claims to be more stable than the conventional one needs to address the danger of asset price bubbles. The question is whether Islamic equity is less prone to asset price inflation.

One of the fundamental difficulties in designing mechanisms preventing asset price bubbles is the identification of a bubble. Already the predecessors of the economic discipline such as Thomas Aquinas and Adam Smith were troubled by the question of “fair” or the “right” price of a good. This article will not engage in the quest for this price. Instead, a very imperfect quantitative proxy shall be used here to assess the resilience of Islamic finance to speculation, namely the volatility of Islamic equity indices in comparison to their conventional counterparts.

The two indices that will be compared are the Dow Jones Industrial Average Index and its Islamic equivalent, the Dow Jones World Islamic Index, launched in January 1996. The Dow Jones Islamic is, of course, not the only Islamic stock price index. In fact, in the last decade, with the rapid growth of Islamic finance, the amount of Islamic stock price indices also increased dramatically. However, the two mentioned indices are used as representative indices for conventional and Islamic stock markets. Hence, if Islamic finance – here in the form of stock prices – is systematically more stable than conventional finance due to structural differences, it will be also detectable in these two indices. Islamic economic theory in fact claims that this is the case [Karwowski (2009)].

The question of whether Islamic indices underperform in comparison to non-Islamic ones is one of the more researched areas of Islamic finance. The term “Islamic index” is somewhat misleading since the attribute “Islamic” rather derives from the type of economic activity that firms included in the index undertake and not so much the index itself [Karwowski (2007)]. Simplifying, Islamic indices can be understood as a differently composed form of a conventional index since they simply exclude companies that do not operate in compliance with the body of Islamic law. Generally, there is no convincing evidence that Islamic equity neither underperforms vis-à-vis nor outperforms conventional equity systematically [Girard and Hassan (2005)].

Industry allocation		
Industry	DJIM index	DJ world index
Basic materials	13.91%	8.20%
Consumer goods	8.56%	11.40%
Consumer services	6.45%	8.83%
Financials	0.26%	22.04%
Healthcare	14.74%	7.71%
Industrials	14.61%	13.65%
Oil and gas	17.36%	9.97%
Technology	15.61%	8.72%
Telecommunications	5.61%	4.66%
Utilities	2.90%	4.81%

Source: Dow Jones 2009

Table 2 – Industry allocation in the Dow Jones Islamic and the Dow Jones

The Islamic Dow Jones World index is in comparison to its conventional counterpart based considerably more on resource extracting industries. Companies dealing with basic materials make up almost 14 percent of the Islamic index while they only account for just over 8 percent in the conventional Dow Jones World. Oil and Gas companies are almost twice as strongly represented in the Islamic Dow Jones as in the conventional Dow. These industries – among others – fill the gaps arising from excluding firms dealing with alcohol, pork-related products, conventional financial services, entertainment, tobacco, and weapons and defense. This explains the lower representation of consumer goods and services, and particularly the finance industry, in Islamic indices in general and the DJIM in particular (Table 2).

The strong representation of commodity-related industries would favor a stronger performance of the DJIM starting in the early 2000s as the resource price boom developed. However, the concurrent flourishing of the financial industry, which is mostly excluded from Islamic indices, might have moderated this performance. Hence, the different compositions of these indices do not give us any conclusive indication about their stability.

Looking at the volatility of the two representative indices no substantial differences can be spotted. Their coefficients of variation are very comparable (20 percent in the case of the Islamic index and 20 percent for the conventional one), indicating that the percentage deviation from their average is approximately similar. If one accepts the intensity of fluctuations around a long-term trend as proxy for volatility, it means that there is no difference between the (in-)stability of the two. More importantly, the evolution of the two indices over time is similar (Figure 2). This means that the Islamic and the conventional index tend to react to the same



Figure 2 – Islamic versus conventional stock price indices

events in the market and in the same direction. In fact, the two indices are correlated with a coefficient of 0.89. A correlation coefficient of 1 indicates that two series move perfectly together while a coefficient of 0 supports the hypothesis that two series are perfectly independent from each other. Hence, the Islamic and the conventional Dow Jones index are highly correlated, moving most of the time in the same direction with the same intensity.

Overall, there is little evidence that Islamic equity indices are detectably more stable than conventional ones.

3. ... because Islamic finance is based on morality

If Islamic finance in actual fact does not differ from conventional finance in the effective utilization of interest or collateral and is not detectably more stable than conventional finance, the only remaining difference is its theoretical basis.

Similar to conventional finance, Islamic finance bases its claim to bring stability and prosperity on orthodox and conventional economic theory. Western neoclassical economics nurtured the ideas that freeing up financial systems – domestically and internationally – by banning “financial repression” through deregulation would bring stability to developed countries and growth to developing ones. Deeper financial markets would help to hedge risk and provide entrepreneurial credit increasing investment leading to growth, conversion of economic welfare, and consequently development. Islamic economics echoes this claim for Islamic finance yet emphasizing morality. Given that excessive risk-taking by financial institutions was denounced as a major cause of the latest crisis, a stress on moral values and ethical behavior does not only appeal to Muslim economists or the Pope.

Sharing profit and loss between creditor and debtor is meant to align their interests, but their shared values and morality are the elements that ultimately ensure trust between the two and make collateral unnecessary. Hence, Islamic scholars claim that the fundamental difference between conventional and Islamic economics is the morality of the “homo Islamicus” in contrast to the rationality of the “homo economicus” [Chapra (2000b)]. Islamic finance and banking are meant to function based on this fundamental morality and derive their claim towards more stability from it.

In times when everyone is talking about missing trust between banks being at the heart of the crisis (showing in dried-out inter-bank lending), this argument portrays Islamic finance as an intriguing alternative to the crisis-ridden status-quo. Here again conventional economic theory can support this claim. In theory, interest-based lending and borrowing – regardless of whether between individuals or banks – happens at the risk-free interest rate r^* up to the point of collateralizable wealth of the borrower, after which the charged interest rate increases the bigger the size of the loan. However, assets that constitute wealth are typically behaving pro-cyclically. In other words, during economic upswings asset prices are increasing, raising the borrower’s wealth and his ability to borrow. During downswings in turn asset prices decline diminishing the borrower’s collateral. Hence, most economists agree that credit cycles tend to exacerbate economic cycles [Bernanke and Gertler (1989)]. In economically turbulent times, when asset prices are in freefall – as we experienced during the recent subprime crisis – the net worth of a potential borrower might even turn negative. Frozen inter-bank money markets can be modeled similarly. The suspicion that other banks might hold worthless assets – i.e., bad debt – decreases banks’ willingness to lend among themselves, which manifests itself in extraordinarily high cost of borrowing. This is equivalent to a collapse in borrower’s net worth and a failure of demand and supply curves to intersect. Economists such as Joseph Stiglitz like to refer to a loss of trust characterizing this kind of situation [Stiglitz (2009)].

From a theoretical perspective, Islamic loans, which do not require collateral, seem like a viable alternative. The fall of collateral value would not take place and would not have the dramatically limiting effect on lending between banks as in the case just described. Furthermore, the trust existing between banks could theoretically ensure the upkeep of inter-bank lending.

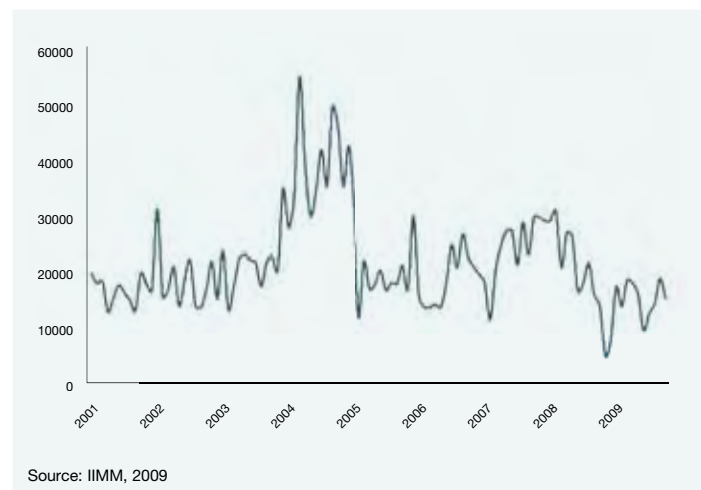
The problem with arguments based on trust is that they are a dead end for logical reasoning. What determines trust? And why should lending be so much dependent on trust? I do not trust my bank assuming that it charges me fees for anything it possibly can. But if I am in financial distress I will borrow from it since I do not have a choice. Equally the bank does not trust me. Consequently, it demands proofs of employment and salary before it lends large sums of money to me.

Is trust stronger in Islamic institutions, namely in Islamic finance? Inter-bank lending between conventional banks dried out almost completely during the hottest phase of the financial crisis. This was interpreted by some economists as sign of lack of trust. Financial markets will only return to a healthy position once this trust is reestablished (interestingly, economists stating this insight rarely clarify how trust could be reestablished).

Did inter-bank lending among Islamic banks remain stable during the recent crisis, indicating more trust among Islamic banks? This question is not easy to answer since Islamic inter-bank lending is not fully developed. Islamic banks tend not to engage as actively in borrowing and lending among each other as conventional banks. Their reserves, therefore, often exceed the legally necessary thresholds substantively. In 2006, Islamic banks in Indonesia held ten times as much excess reserves as their conventional counterparts, namely 20 percent of total deposits [Islamic Financial Services Board (2008)]. Furthermore, if Islamic banks engage in inter-bank money transactions they in fact mostly interact with the central bank or government institutions. Instruments purchased in inter-bank money markets are rarely traded in secondary markets but rather held until maturity. These observations are simultaneously the reason for and the result of a poorly developed secondary market for Islamic inter-bank lending instruments [Islamic Financial Services Board (2008)]. Yet, this fact could be interpreted as a lack of trust among Islamic banks. Surely if they prefer to borrow from the lender-of-last resort, the central bank, and not from fellow banks, Islamic banks cannot possess a lot of trust in each other.

Arguably, the low inter-bank lending volumes are a result of the complicated structure of Islamic inter-bank lending. Since finance activity needs to be asset-backed Islamic inter-bank transactions typically involve purchases and sales of commodities to back the actual borrowing or lending. Any generated profit by the borrowing bank has to be shared with the lending bank since profit-and-loss sharing is mostly the basis of such transactions. In Malaysia, this share of profit that the lender receives in exchange for its funds has to be dictated by the regulator since Islamic banks used to understate their profits in order to minimize payments to banks from which they borrowed [Bacha (2008)]. This may be anecdotal evidence that trust among Islamic banks is not sufficient to ensure the stability of inter-bank operations and regulation is as crucial for Islamic as for conventional finance.

Hence, morality and trust do not seem higher in Islamic finance. Reviewing data on inter-bank transactions in Malaysia, which possesses the most advanced Islamic inter-bank market, this argument is further strengthened. Malaysia was hit by the financial crisis and global recession only by late 2008 mainly through the channel of trade and financial flows. At the same time, dramatically falling lending volumes for short-



Source: IIMM, 2009

Figure 3 – Short-term Islamic inter-bank transactions in the Islamic inter-bank money market

term inter-bank lending transactions could be observed in the Islamic inter-bank money market. The volume of Islamic short-term inter-bank instruments – including overnight and weekend transactions as well as transactions over the periods of one week and one month – hit an all-time low by November 2008 falling to 4707. The long-term average since the Islamic inter-bank money market was launched in January 2001 is 21887 transactions per month. Earlier low points never fell below a volume of 11000 transactions per month (Figure 3).

Evidently, the financial crisis had a profound impact on the Islamic inter-bank money market. A complete drying-out was probably avoided through the extensive involvement of the Malaysian Central Bank in the market. Equally, conventional inter-bank lending was revived through central bank engagement either via direct liquidity injection or guarantees backing money market transactions. Hence, conventional and Islamic inter-bank lending function very similarly.

Conclusion

In conclusion, there is little reason to believe Islamic finance is fundamentally different from conventional finance. Its apparent resilience to the current crisis in certain areas – such as the Islamic inter-bank money market in Malaysia – is rather a symptom of its underdevelopment. Once, Islamic finance steps through the door of the financial mainstream it is more than likely to exhibit the same characteristics. In this respect, Islamic finance can be a religion-based version of the religion-like belief in the self-regulating and self-stabilizing conventional finance. This belief contributed a great deal to the destabilizing trends in current financial structures.

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