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**Islamic Mortgages: A Comparative Study to Improve the Legal and
Financial System of Mortgages in the Royal Kingdom of Saudi Arabia
with a Regulatory Analysis of the US and UK, and
Case Analyses of the UK, Sharjah, Dubai and Saudi Arabia**

ARWA ALISSA

**A thesis submitted in partial fulfilment of the requirements of the University of
Westminster for the degree of Doctor of Philosophy**

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Abstract

This research is the first comprehensive critical evaluation of the ways in which Islamic mortgages can be developed and executed in a Sharia compliant manner in order to boost the development of housing markets primarily in Saudi Arabia, with regulatory analyses of securitisation in the US and EU, and case analyses of the UK, Sharjah, and Dubai. The regulatory analyses of securitization show how the excesses of modern financial legal techniques to greatly expand opportunistic developments of mortgage-backed markets led to market failures, and that such market failure could be avoided by the use of Islamic finance principles. These case analyses have been selected to provide a spectrum of different socio-economic contexts in which to compare the Saudi Arabian system. The study also engages in the examination of the Western and Islamic legal systems and their impact on mortgaging and securitisation theory and practice.

Securitisation, namely the activity involving the packaging, dividing and selling of mortgages in the primary market has in recent years become a well-established business process (with banking, financing and legal implications and aspects) for enhancing home financing and home ownership in the USA, the UK and Western Europe, all of which are subject to common law contractual processes. However, it would be natural to suppose that further development of the Saudi Arabian and other Islamic legal systems would include securitisation techniques in the near future. Indeed, certain Islamic finance structures lend themselves to securitisation processes which are investigated in depth in this work.

Banking and financial activities in the Islamic countries are however governed by a mix of conventional practice, common law and Islamic law, with variations occurring in the same between different jurisdictions. This study aims to engage in a detailed comparison of the conventional (Western) banking system and the banking procedures and processes followed in Islamic jurisdictions in order to develop and recommend a standardized securitisation system for mortgages, which draws upon the best of western regulations and practices and is yet compliant with Islamic law, i.e. the Sharia.

The Western banking system is based upon intermediation between entities that have money and ones that need to use it, the charging of interest and a rational decision-making process between banks and their clients. The Islamic system on the other hand is governed by Islamic law, which prohibits interest, speculation and any type of activity that is perceived to be oppressive. It recommends close partnerships between bankers and clients, rather than short-term transactional utility. The establishment of common ground

between these two systems is undoubtedly a challenging task, particularly because of the differences in the interpretation of religious law by different clerics. This study however points out that significant common ground can be established if standardisation of legal practices and bank policies can be achieved in Islamic countries. The development of high levels of standardisation will help in the creation of securitisation processes for housing mortgages that are Sharia compliant and thus satisfy two important objectives, namely religious requirements and the expansion of the housing market.

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Author's declaration

I declare that all the material contained in this thesis is my own work

Table of Definitions

Islamic Finance Terms	Glossary
Al-'inah	Combination of a contract between two parties that combines cash purchase with deferred sale.
Al-mustasni'	An individual who asks for construction of a house.
Al-sani'	A builder who responds to Al-Mustasni
Al wadiah	Sharia Compliant deposit
Amanah	Honesty, trustworthiness and faithfulness
Amin	Custodian
Arbun	Down payment by buyer to seller
Bai' al-arbun	Contract for sale with EMD (Earnest Money Deposit)
Bai' al dayn	Sale of outstanding or debt
Dayn	Contractual liability or debt
Dhaman	Assumption of responsibility or liability
Fatwa	Announcement by Sharia expert on religious compliance of transaction
Fiqh	Islamic law
Gharar	Uncertainty
Hamish Jiddiyah	Earnest Money deport for purchase of asset
Hilah (Hiyal (pl)):	Transactional tricks for achieving wrong outcomes
Ijara	Leasing agreement
Ijtihad	Reasoning process
Ijma	Agreement amongst scholars
Istisna	Sale contract for a future asset
Jahl or Jahala	Absence of knowledge
Kafalah	Guarantee
Maysir	Speculations / gambling
Mudharabah	Partnership for investment

Mudarib	Investment manager
Mujtahid	Qualified Sharia interpreter
Murabaha	Purchase and subsequent resale
Musharaka	Sharing of profits and losses
Musharaka Mutanaqisah	Reducing partnership
Qard	Repayable loan; borrowed money has to be repaid by specific period
Qard al Hassan	Virtuous loan where borrower can repay when he wishes
Rabb ul-maal	Mudaraba investors
Riba	Interest
Sarf	Contract involving exchange of gold, silver or money
Sharia	Sharia Islamic Law
Sukuk	Conventional bonds
Takaful	Islamic insurance
Tawarruq	Islamic method for obtaining cash
Ummah	Members of Islamic community
Wa'd	Business promise
Wakala Istismar	Agency for investment
Waqf	Property that benefits class of people or organisations
Zakat	Wealth based religious tax

Table of Abbreviations

Terms	Abbreviations
ABS	Asset Based Securities
SEC	Securities Exchange Commission
AAOIFI	Accounting and Auditing Organisation for Islamic Finance Institutions
FSA	Financial Services Authority
FSMA	Financial Services and Markets Association
CIBAFI	Council for Islamic Banking and Financial Institution
LCR	Liquidity Coverage Ratio
STS	Standardised and Transparent Securitisation
GCC	Gulf Cooperation Council
GBP	Great Britain Pound
CRA	Credit Rating Agency
SPV	Special Purpose Vehicle
IMF	International Monetary Fund
USD	United States Dollars
AED	United Arab Emirates Dirham
LTV	Loan-To-Value Ratio
DBR	Debt Burden Ratio
OPT	Options Pricing Theory
EMH	Efficient Market Hypothesis
CAPM	Capital Asset Pricing Model
FFM	FAMA French Model
DM	Diminishing Musharaka
SIB	Sudan Islamic Bank
DCCI	Dubai Chambers of Commerce and Industry
OIC	Organisation of the Islamic Conference
SAMA	Saudi Arabian Monetary Agency

Chapter 1: Introduction

1.1 General Introduction

One of the major problems facing the practice of Islamic finance is that, in many cases, *Murabaha* mortgages are not actually in full compliance with the *Sharia* requirements that are outlined in the Quran.¹ This is due to the fact that the option of early repayment, which is offered by some non-Muslim financial institutions to consumers, contradicts the requirement for the price of the asset to be changed under any circumstances, and for no rebate to be made to customers in the case of early repayment.² Another obvious instance in which the provision of a *Murabaha* contracts violate the *Sharia* requirements is in the case of the signing of the asset's offer and acceptance agreement, which, in secular terms, is typically delayed and is usually not used as proof that the purchase of the asset was implemented.³ It is argued, therefore, that there are a number of areas in which the products that are marketed at Muslim consumers actually fail to meet the strictures contained in the Koran.

One of the aims of the proposed dissertation is to analyse the extent to which the Islamic mortgages that are offered to Muslim consumers in various jurisdictions comply with prevailing Islamic law, and the extent to which such mortgages are associated with socio-economic advantages, when compared to their secular counterparts. As outlined within the title, the proposed thesis will analyse the extent to which Islamic mortgages that are offered by non-Islamic financial institutions are actually compliant with *Sharia* law, and whether consumers of Islamic mortgages are able to benefit from any socio-economic advantages, when compared to consumers of secular mortgages. The question of the extent to which Islamic financial products are actually *Sharia* compliant has already been raised with respect to other Islamic financial products, with Sheikh Muhammad Taqi Usmani asserting that 85 percent of Islamic bonds are un-Islamic.⁴ However, the same analysis has not been applied so far to other Islamic financial

¹ Baele, L., Farooq, M., & Ongena, S.R.G., “*Of religion and redemption: evidence from default on Islamic loans*”, (2011), <http://cepr.org/active/publications/discussion_papers/dp.php?dpno=8504>

² Haassan, K., & Mahlknecht, M., *Islamic capital markets: products and strategies*, (NY: John Wiley & Sons, 2011).

³ *Ibid*

⁴ Goddard, A., “The Mortgage Credit Directive: how will this impact UK lenders?”, (2014), <http://www.addleshawgoddard.com/view.asp?content_id=7360&parent_id=6606>

products. The thesis focuses mainly on the provision of *Murabaha* mortgage contracts, in conjunction with other Islamic mortgage products such as diminishing *Murashaka* and *Ijara*.

The broad outline of the thesis, namely the brief description of the various chapters is provided in this subsection. This introductory section provides a brief description of the contents of the different chapters, details about the research question, the central argument of the study, a summarisation of the methodology, the case studies carried out in the course of research for this project and a summative conclusion.

The research question embodies the basic reason for carrying out this research project and has been developed in detail in order to provide a route map for the research project. It also provides details about the key arguments of the study, the theoretical framework on which research will be based, a summarisation of the methodology, contributions from other disciplines and a summative conclusion.

The second chapter provides details about the research method adopted for this study and the reasons for its selection. The choice of an appropriate research method plays an extremely important role in the development of research findings and outcomes and the selection of an inappropriate research approach can very well result in wrong findings and misleading outcomes. With social research being a complex discipline characterised by the presence of different research epistemologies, tools and techniques, the selection of an appropriate research method has to be carried out with great care and thought. This research project has been carried out with the help of a qualitative approach and the use of case studies on the application of Islamic financial systems in the UK, Sharjah, Saudi Arabia and Dubai. The application of the case study method of research has increased significantly in modern social research on account of its facilitation in the development of in-depth and relevant findings. Whilst the case study method of research has been subjected to some criticism on account of its focus on an extremely limited number of research objects for study, this limitation is by and large overcome with the help of carefully chosen cases and the study of two or more cases for bringing about greater representativeness. This research study makes use of four case studies, namely the use of Islamic mortgages in the UK, Saudi Arabia, Sharjah and Dubai. Such a choice has ensured the examination of Islamic mortgaging practices in the GCC countries, which follow the tenets of Islamic law in various degrees and the UK, where all banking and business activities are guided by common law. Such an approach has helped in the conduct of multidimensional and in-depth

study of Islamic mortgaging policies and practices. The use of the case study method of research has been productively used by researchers like Kettell⁵ and Misman and Bhatti⁶ with useful and informative outcomes. Whilst these two research studies have not been submitted for PhD's, they are nevertheless important from the perspective of detailed research and useful information. Qasem however carried out a case study based dissertation study on Islamic banking regulation and supervision in Jordan. His effort resulted in the successful awarding of a PhD by Loughborough University.⁷

The third chapter contains a detailed review of the literature available in the public domain on the subject. The review has been carried out with the application of keyword based detailed online search of publications on the research issue. These publications, comprising books, research studies, journal and magazine articles, organisational websites and other media publications have been carefully examined with regard to relevance and reliability of the information source as well as its date of publication. More than a 100 carefully chosen information sources have been chosen for this project, of which approximately 65 have been used for the review of literature. The review of literature has helped in the development of comprehensive understanding of the subject and the generation of a specific direction for the conduct of research.

The fourth chapter provides details on the modern law of securitisation, comparing and contrasting it with the ancient law of mortgages. Whilst mortgaging is an age-old practice for the raising of finance and has been used by borrowers and lenders for centuries, modern western bankers have introduced the concept of securitisation of these mortgages and have thereby developed it into an extremely powerful financial tool with very substantial national and organisational consequences. With the misuse of securitisation being considered an extremely significant driver of the financial crisis of 2008, there is wide realisation that it needs to be handled with care and thought in order to ensure the prevention of systemic risks. The study of

⁵ Kettell, B., "*Case Studies in Islamic Banking and Finance*", (2011), <<https://nurulichsanaan.files.wordpress.com/2015/10/introduction-to-islamic-banking-and-finance-case-studies-case-questions-answers-brian-kettell-2011.pdf>>

⁶ Misman, F.N., & Bhatti, M.I., "*Risks Exposure in Islamic Banks: a Case Study of Bank Islam Malaysia Berhad (BIMB)*", (2009), <<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan049142.pdf>>

⁷ Qasam, A.A., "*Islamic banking regulation and supervision: a case study of Jordan*", (2004), <<https://dspace.lboro.ac.uk/dspace-jspui/handle/2134/7613>>

this issue, comparing and contrasting with historical practices has helped in the development of an appropriate academic background for the research project.

The fifth chapter contains researched details about the four case studies, i.e. the application of Islamic finance in the UK, Sharjah, Saudi Arabia and Dubai. These countries have been chosen because of their increasing use of Islamic finance products. Islamic finance and banking is growing steadily in the UK and the country has become an Islamic finance hub in the western world. The fact that banking in the UK is governed by common law and directives established by regulatory authorities like the Bank of England makes this case especially important and provide information on the likely direction of growth of Islamic banking in other non-Islamic countries. The other three countries, namely Sharjah, Saudi Arabia and Dubai are affluent Middle Eastern countries with thriving economies and steadily expanding capital markets and banking sectors. With these countries also being governed by Islamic law, their study has helped in understanding the various challenges and problems that can be faced by Islamic banks, with specific regard to securitisation on account of non-standardisation of religious approaches to the issue.

The next chapter, i.e. chapter six contains a detailed analysis and discussions of the information obtained in the course of the conduct of research. The discussion has been carried out on a thematic basis and specific themes that are relevant for the answering of the research question have been sequentially taken up for examination, discussion and critical analysis. The findings from the four case studies have been examined in isolation, as well as collectively in order to determine current Islamic banking trends, challenges, opportunities and difficulties. These findings have been compared and contrasted with the information obtained in the course of the literature review in order to arrive at comprehensive and well-studied outcomes.

The seventh chapter contains conclusions and recommendations. This chapter provides information on the aims and objectives of the study, the research findings, the information obtained from the literature review, an outlining of the research method, and the gist of the discussions and analysis carried out for the study. The section also contains several recommendations for Islamic bankers on the steps they can take to integrate securitisation in their banking practices in a systematic and methodical manner in the coming years.

1.2 Research Questions

The European Union issued the Mortgage Credit Directive, i.e. Directive 2014/17/EU in February 2014, making it mandatory for implementation by 21st March 2016. The directive covered a broad variety of credit agreements, including home mortgages and finance. It was thus specifically applicable to the home finance plans provided by Islamic banks and thus included Murabaha mortgages amongst others. The EU, by issuing this directive aimed to achieve standardisation and harmonisation in the provisioning and marketing of home credit across the EU in order to enhance customer protection. It needs to be considered at this stage that Islamic finance and banking practices are governed to a large extent by the Sharia, i.e. Islamic law. This is in clear contrast to banking operations in the conventional western banking system, which are governed by common law and the rules and regulations of local governmental and banking regulators. The Sharia has developed over hundreds of years and has been enriched by contributions from Islamic theological experts in various Islamic countries. The Sharia is also subject to interpretation by different experts whose views often diverge on different aspects.

This phenomenon has resulted in a marked lack of standardisation and divergence between the Sharia guidance for bankers, not only from country to country but also within countries and even within cities. Such lack of standardisation creates confusion in the minds of customers and compels them to examine the home finance offerings of different banks in order to decide upon the scheme that would meet their particular requirements. Islamic banks now have in-house Sharia specialists, who provide advice to the bank managements, ensuring that their products are Sharia compliant.

The application of the EU directive is thus bound to have a significantly disturbing impact on the complete home finance business, operated by Islamic banks through their Murabaha schemes.

The research question for this dissertation is elaborated as under.

Main Research Question

How can Islamic banking procedures be modified to bring about higher degrees of Sharia compliance, standardisation and harmonisation?

Subsidiary Research Questions

Research Question 1: Why should mortgage laws, with regard to Islamic banking be modified?

Research Question 2: How can Islamic mortgage law be made beneficial for providers and users of funds and society at large?

Research Question 3: How can the markets for Islamic mortgages be enhanced?

This research study aims to answer the research question by examining diverse aspects of banking theory and practice, with specific regard to home finance in the context of both western and Islamic banking in order to obtain a thorough understanding of the subject. This research project involves the study of Islamic home lending banking practices in four geographies, namely the UK, Sharjah, Saudi Arabia and Dubai in order to determine existing challenge, difficulties and problems and recommend ways and means that can be adopted to bring in greater standardisation and improve Sharia compliance in the process across the world. This is essential to ensure the logical and steady expansion of Islamic banking in the area of home lending with adequate care being given to customer satisfaction and management of risks.

1.3 The Central Argument

This research project aims to examine the role, relevance, advantages and challenges of Islamic banking in the contemporary banking environment, with specific regard to the application and exploitation of securitisation for the enhancement and optimisation of mortgage financing activity. Western and Islamic banking are based upon very different assumptions. Whilst both banking systems aim to provide finances to individuals and entities for different purposes, western banking perceives the process to be a business opportunity for the earnings of profits, whereas Islamic banking looks at it as a cooperative process for ensuring of equitable social development. Western banking is thus based upon intermediation, the development of arm's length and unemotional relationships between lender and borrower and the charging of interest in return for provisioning of loans; Islamic banking is however based upon close cooperation between the provider and user of finances, the prohibition of interest and the sharing of risks, profits and losses. Islamic banking is furthermore governed by Islamic law, whereas western banking is regulated by common law, the government and the central bank.

There is little doubt that western banking activity has expanded enormously over the years, driven by the profit and growth seeking ambitions of banking organisations and the continuous growth of the global economy. It has been enriched by diverse types of innovations and technological advancements that have provided it with the ability to operate across countries and continents and make use of globalisation and liberalisation to expand across the world. The development of recent financial innovations like securitisation, credit derivatives and special purpose vehicles have enabled western bankers to enhance their borrowing lending capabilities enormously. Securitisation has, in particular, developed into a widely used business process and a strong operational tool for enhancement of mortgaging activities as well as home financing, especially in the USA, the UK and West Europe. It would not be unnatural to presume that growth of islami9c financing systems would incorporate the use of securitisation techniques in the coming years. These tools have however also resulted in the generation of extensive systemic risk. The financial crisis of 2007/2008 occurred primarily because this risk crystallised on account of large scale loan default by poorly chosen mortgage customers in the USA. The Islamic banking sector remained comparatively unaffected by the financial crisis on account of its in-built religious restrictions on engagement in various types of speculative activity.

Various research studies conducted after crisis of 2008 have revealed that the Islamic banking and mortgage systems have substantial risk resilience on account of the close connection between bankers and users of funds, the sharing of risk, profits and losses by both parties and the prohibition of some types of speculative and risky activity. Notwithstanding the presence of such benefits, Islamic banking continues to be disadvantaged on account of lack of standardisation, as well as the divergent views of different Sharia experts. It is also a matter of concern that whilst the absence of standardisation confuses customers, many of them can also be concerned with the fact that some banks follow processes that do not, in full measure, comply with the tenets of the Sharia. Such lack of compliance can result in alienating existing and potential customers who are desirous of availing Sharia compliant banking services.

These deficiencies can result in substantial inconvenience to customers and can retard the growth of the Islamic banking sector, especially in the western world, where it has to compete strongly with an entrenched western banking system and a consumer base that is multicultural in nature. It is thus felt that careful and logical efforts by the Islamic banking fraternity to ensure Sharia compliance in a uniform manner across banking geographies will enable it to offer useful

banking products, especially in the area of home mortgage to its customers across the world and enabling to expand in a systematic manner in different geographies. It is also conceivable that Islamic banking will be able to make use of securitisation but with greater protection against the risks that became evident in the western banking system consequent to the financial crisis of 2008. The achievement of high levels of standardisation, as well as Sharia compliance will help in the development of importance inputs across the Islamic banking fraternity on the ways and means that can be adopted to develop attractive Murabaha products for customers and help them in their efforts to generate home finance in a Sharia compliant manner.

1.4 Theoretical Framework

The majority of research that has focused on Islamic financial products and, in particular, on the issue of their standardisation, has been based upon the economic theory of agency that was developed by Jensen and Meckling.⁸ The original economic theory focused initially on firms as consisting of a nexus of contracts, although it quickly came to be applied to numerous other areas.⁹ According to Jensen and Meckling, the contracts that are established between the agent (the workers) and principal (the owner) of a firm aim to ensure that both parties are maximising the organisation's value while also acting in their own self-interest.¹⁰ When extended to society, this theory refers to the fact that individuals have access to different sets of resources, which commonly may not be sufficient to meet their needs, in other words, 'a mix of resources will be present in any societal setting where situations of interdependence will exist'.¹¹ The pooling together of resources can result in the increase of gains due to the specialisation that arises due to carrying out joint activities; within the context of a firm, this refers to the situation in which the agent's skills and knowledge are used to achieve a fixed goal within the organisation, with the contribution of the capital which is provided by the principal.¹² Within the framework of a society, however, there is no contractual arrangement and therefore there, if one assumes the

⁸ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁹ *Ibid*

¹⁰ Candemir, N.T., "Agency theory: an extended conceptualisation and reformulation", (2005), <http://eprints.qut.edu.au/16188/1/Nurcan_Temel_Candemir_Thesis.pdf>

¹¹ Balala, M.H., *Islamic finance and law: theory and practice in a globalised world*, (NY: I B Tauris Co Ltd, 2011).

¹² Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

agent to be a self-interested rationalist, there is likely to be considerable asymmetry since the agent will be working to further his own self-interest.¹³

In the context of the harmonisation of *Sharia* compliance within Islamic mortgages, this can be formulated in the model of a highly complex multi agent community. While multiple agents have similar capabilities and abilities in terms of their rationality, their range of behaviour is diverse, and their process of reasoning has an increased level of complexity due to the impacts of affiliation and interaction, as demonstrated in a simulation conducted by Temel.¹⁴ This implies that the implementation of any form of trans-national harmonisation of *Sharia* principles would be associated with a high degree of complexity. Institutional influences and differences in the governmental structure of different countries are likely to affect the extent to which agents are committed to the achievement of a common goal, namely, harmonisation.¹⁵ This suggests that, while some countries are likely to be successful in taking steps towards harmonisation, others are less likely to be successful. This is elaborated upon by Candemir who argues that, within such a complex multi-agency setting, the harmonisation of *Sharia* principles concerning Islamic mortgages is only likely to be successful if all agents demonstrate behaviour that encourages harmonisation whilst also taking steps to constrain any action that deters harmonisation.¹⁶ This subject has been taken up in greater detail in the section on secular finance theory in the literature review.

1.4.1 Financial Theory to Macro-Economic View

Several financial experts criticised various tenets of modern finance theory stating that the failure of orthodox economists in predicting the financial crisis clearly revealed that the modern finance theory was essentially flawed.¹⁷ The UK Financial Services Authority published the Turner Review, a regulatory response to the global banking crisis in 2009, which contended that financial markets could not be modelled adequately as efficient interactions between rational agents, leading in turn to equilibrium; this in effect rejected practically the entire structure of

¹³ Balala, M.H., *Islamic finance and law: theory and practice in a globalised world*, (NY: I B Tauris Co Ltd, 2011).

¹⁴ Candemir, N.T., "Agency theory: an extended conceptualisation and reformulation", (2005), <http://eprints.qut.edu.au/16188/1/Nurcan_Temel_Candemir_Thesis.pdf>

¹⁵ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

¹⁶ Candemir, N.T., "Agency theory: an extended conceptualisation and reformulation", (2005), <http://eprints.qut.edu.au/16188/1/Nurcan_Temel_Candemir_Thesis.pdf>

¹⁷ Tobias, A., & Shin, H.S., "*Financial Intermediaries and Monetary Economics*", Chapter 12 in *Handbook of Monetary Economics 3*, eds. (Benjamin Friedman and Michael Woodford, pp. 601–650. Amsterdam: North-Holland, 2011).

orthodox modern finance theory, as it has developed from the 1950s to the present day.¹⁸ Lord Turner stated that the financial crisis was a consequence of the cumulative impact of several decades of grave intellectual error and faulty design of policy.¹⁹ The notion about inherent flaws in orthodox economic models of the financial system was deeply flawed as demonstrated by the financial crisis gained credence and spread.²⁰ The head of the FSA in fact agreed that such models were not of much use even for the informing and shaping of financial regulation.²¹ Greater focus was placed upon other approaches like irrational exuberance, analysis of disequilibrium, non-linear network impact and herding amongst others. The core models of orthodox finance theory are taken up briefly for discussion here below.²²

The Capital Asset Pricing Model

The capital asset pricing model is used to determine a theoretically appropriate required rate of return of an asset to take decisions about adding assets to a diversified portfolio.²³ CAPM is used widely throughout finance for the pricing of risky securities, generating expected returns for assets, given the risks of those assets, and for calculating costs of capital.²⁴ The general idea behind the CAPM is that investors should be compensated in two ways, i.e. after taking account of the time value of money and risk.²⁵

The Modigliani Miller capital structure irrelevance theorem explains how asset value and pricing does or does not depend upon how investment is financed between debt and equity.²⁶ It states that the market value of a company is calculated using its earning power and the risks of its underlying assets and is by and large independent of the ways in which it finances investments or distributes dividends.²⁷ Whilst somewhat complicated, the theorem, in its simplest state, is based upon the concept that there is no difference between a firm financing itself with debt or equity when certain assumptions are in place.²⁸

¹⁸*Ibid*

¹⁹ Tobias, A., & Shin, H.S., "Money, Liquidity and Monetary Policy," *American Economic Review*, 99, 2, (2009): 600-605.

²⁰*Ibid*

²¹*Ibid*

²²*Ibid*

²³French, C.W., *The Treynor Capital Asset Pricing Model*, *Journal of Investment Management*, 1, 2, (2003): 60–72.

²⁴*Ibid*

²⁵*Ibid*

²⁶Fama, E.F., French, K.E., "The Capital Asset Pricing Model: Theory and Evidence", *Journal of Economic Perspectives*, 18, 3, (2004): 25–46.

²⁷*Ibid*

²⁸*Ibid*

The efficient market theory explains what does and what does not determine how prices in financial markets change through time.²⁹ It is an investment theory that states that it is impossible to beat the market because stock market efficiency constantly results in existing share prices incorporating all relevant information.³⁰ The EMH states that stocks always trade at their fair value on stock exchanges, which makes it impossible for investors to buy undervalued shares or sell stocks at inflated prices; it is thus impossible to outperform the overall market through market timing or expert stock solutions.³¹ The only way in which an investor can possibly achieve higher returns is through the use of riskier investments.³² The Options Pricing Theory (OPT), particularly the Black-Scholes model avers that the pricing of composite assets made of clamps other than other financial assets.³³ A call option gives the buyer the option to buy the underlying asset at a fixed price termed the strike or exercise price at any time before the expiration date of an option; the difference between the asset price and the exercise price constitutes the gross price on the option investment.³⁴ The Black-Scholes model has margins for error, because its values are derived from other assets, generally the price of the company's common stock.³⁵ The main finance theory models remained unchanged eight years after the crisis, except in two areas.³⁶ There was firstly a serious prospect before the crisis that the CAPM might be replaced by other models like the Fama French Model (FFM) for important purposes; that pressure has disappeared entirely since 2008.³⁷ Fama and French stated that the CAPM performed excellently during the crisis and far better than what its advocates would have anticipated under such extreme circumstances.³⁸ It has provided a robust framework for analysing developments, drawing conclusions and making recommendations.³⁹ The CAPM has in fact formed the sole basis for analysis for various regulatory decisions and code decisions since 2009.⁴⁰ There appears to be secondly more suspicion now about the use of normality assumptions in options pricing models that were based upon relatively short historic data

²⁹Rubinstein, M., *A History of the Theory of Investments*, (Hoboken: John Wiley & Sons, Inc, 2006).

³⁰*Ibid*

³¹*Ibid*

³²*Ibid*

³³Bodie, Z., Kane, A., & Marcus, A. J., *Investments*, (Boston: McGraw-Hill, 2008).

³⁴*Ibid*

³⁵*Ibid*

³⁶Sinkey, F. J., *Commercial Bank Financial Management*, 6th Edition, (NJ: Prentice Hall, 2002).

³⁷*Ibid*

³⁸Fama, E.F., French, K.E., "The Capital Asset Pricing Model: Theory and Evidence", *Journal of Economic Perspectives*, 18, 3, (2004): 25–46.

³⁹*Ibid*

⁴⁰Tobias, A., & Shin, H.S., "Money, Liquidity and Monetary Policy," *American Economic Review*, 99, 2, (2009): 600-605.

sets.⁴¹ Rajan stated that macroeconomic and generic event flow has come to dominate micro economic and idiosyncratic event flow in the application of these models.⁴² It is important to note that the main models of finance theory have not altered in the light of the financial crisis and that orthodox models have become even more entrenched in economic theory and practice.⁴³ Whilst some experts did claim that orthodox economic theory ought to have been able to predict the financial crisis of 2007-2009, this appears to be a misplaced comment.⁴⁴ A report for the European parliament attributed the financial crisis to 7 important factors.⁴⁵ These are elaborated here under.

- Financial innovations did not turn out to be as valuable as anticipated in the beginning.
- Dependence upon regulatory badging increased; regulators commenced determining the ways in which risk analysis was to be done with the consequence that it was considered that a mistake by a regulator systematically coordinated error.
- Internal risk management declined in quality with consumers increasing their dependence upon regulatory badges.
- Regulatory circumventions of barriers.
- Uninformative volatility in pricing being driven by speculation.
- Weaknesses in monetary policy regimes resulting in excessively low rates of interest.
- Explicit or implicit bailout promises by government.⁴⁶

Pelzer stated that whilst macroeconomic models were used to explain the causes of the financial crisis, these were not integrated with models of financial economics and tended to lack any explicit financial sector.⁴⁷ Pelzer stated that macroeconomics is organised into different schools of thought with differing views on the ways in which markets and their participants

⁴¹ *Ibid*

⁴² Rajan, G. R., *Fractures Still Fault Lines: How Hidden Threaten the World Economy*, (Princeton University Press: Princeton, 2010).

⁴³ *Ibid*

⁴⁴ *Ibid*

⁴⁵ *Ibid*

⁴⁶ *Ibid*

⁴⁷ Pelzer, P., *Risk, Risk Management and Regulation in the Banking Industry: The Risk to Come*, Routledge International Studies in Money and Banking, (UK: Routledge, 2012).

operate.⁴⁸ Classical economists essentially state that prices, wages and rates are flexible and markets are always clear.⁴⁹ With there being no unemployment, growth depends upon the supply of production factors.⁵⁰

Keynesian economics focuses upon aggregate demand as the principle factor in issues like unemployment and the business cycle.⁵¹ Advocates of Keynesian economics argue that the business cycle can be managed by active governmental intervention through the adoption of appropriate fiscal policy, i.e. engaging in greater expenditure in recessions for stimulating demand, and monetary policy, i.e. stimulation of demand with lower rates.⁵² They also argue that certain system rigidities, like sticky prices and wages prevent the suitable clearing of demand and supply.⁵³ The monetarist's school, which is largely influenced by Milton Friedman, argues that the government should be responsible for controlling inflation by controlling the money supply.⁵⁴

Monetarists state that markets are generally clear and that participants have rational expectations.⁵⁵ They reject the Keynesian concept that governments can manage demand and state that attempts to do so result in destabilisation of the system.⁵⁶ The new Keynesian school builds upon traditional Keynesian economic theory and states that households and firms operate on the basis of rational expectations; a variety of market failures however still occur on account of wages and sticky prices.⁵⁷ Governments can in such case enhance macroeconomic conditions through monetary and fiscal policy.⁵⁸

Neoclassical economic theory is based on the assumption that people have rational expectations and make efforts to maximise their utility.⁵⁹ The school of thought presumes that people by and large act independently and on their own on the basis of the information obtained by them.⁶⁰ The neoclassical school is considered responsible for generating the idea of

⁴⁸*Ibid*

⁴⁹*Ibid*

⁵⁰*Ibid*

⁵¹Fletcher, G., *The Keynesian Revolution and Its Critics: Issues of Theory and Policy for the Monetary Production Economy*, (Palgrave MacMillan, 1989).

⁵²*Ibid*

⁵³*Ibid*

⁵⁴*Ibid*

⁵⁵Sullivan, A., & Sheffrin, S.M., *Economics: Principles in action*, (Upper Saddle River: Pearson Prentice Hall, 2003).

⁵⁶*Ibid*

⁵⁷*Ibid*

⁵⁸*Ibid*

⁵⁹Ferguson, C.E., *The Neoclassical Theory of Production and Distribution*, (Cambridge, 1969).

⁶⁰*Ibid*

marginalism and the maximisation of marginal utility as well as the idea that economic agents tend to work on the basis of logical expectations.⁶¹ With neoclassical economists tending to believe that the market was always in equilibrium, macroeconomics focuses on the expansion of supply factors and the influence of money supply on price levels.⁶²

The New Classical School builds on the neoclassical school and stresses upon the importance of microeconomics and models based upon such behaviour.⁶³ Advocates of the school assume that agents have rational expectations and tend to maximise their utility.⁶⁴ They assume that the market clears at all times, that unemployment is by and large voluntary and that discretionary fiscal policy can result in destabilisation whereas inflation can be controlled with suitable monetary policy.⁶⁵

1.4.2 Micro-Economic View: Coase; Jenson and Meckling

Coase, was amongst the first academics to question the reasons for existence of firms and what exactly a firm was.⁶⁶ Both of these issues are essential for the understanding of corporate governance and the operations of Islamic financial institutions.⁶⁷ A firm, before the 1930s was essentially perceived as a black box that was felt was likely to behave like any other economic actor focused on self-interest and maximisation of utility.⁶⁸ Adam Smith has briefly focused upon the challenges that were likely to develop from the separation of control and ownership in firms.⁶⁹ It however took more than a century and a half after Adam Smith for economists like Coase and Williamson to develop theories around such issues. Such questions have caught the attention of several economists and lawyers since Coase published his seminal article in 1937.⁷⁰ Several economists continue to make use of neoclassical economic tools for explaining the reasons for conduct of business activities with the structure of a firm and for the development of diverse policy implications in corporate governance.⁷¹ Proposals for corporate governance and

⁶¹ *Ibid*

⁶² *Ibid*

⁶³ Clark, B., *Principles of political economy: A comparative approach*, (Westport, Connecticut: Praeger, 1998).

⁶⁴ *Ibid*

⁶⁵ *Ibid*

⁶⁶ Coase, R.H., "The Nature of the Firm," *Economica*, 4, (1937): 386–405.

⁶⁷ *Ibid*

⁶⁸ Foss, N.J., "Knowledge-Based Approaches to the Theory of the Firm: Some Critical Comments," *Organization Science*, (1996): 470-476.

⁶⁹ Smith, A., *The wealth of nation*, Cannan edition, (Modern Library: New York, 1937).

⁷⁰ Mäki, U., "Is Coase a Realist?" *Philosophy of the Social Sciences*, 28, 1, (1998): 5–31.

⁷¹ González-Díaz, M., & Vázquez, L., "Make-or-Buy Decisions: A New Institutional Economics Approach," In *New Institutional Economics: A Guidebook*, ed. É. Brousseau and J.-M. Glachant. (Cambridge: Cambridge University Press, 2008).

company law are thus based on the specific understanding of the reasons for existence of firms and the interests that should be served by them. There is thus little doubt that the theory of the firm is indispensable to carry out any discussion on the development of financial products, Islamic or otherwise.⁷² The firm, until the 1930s was regularly perceived as a black box that was self-interested, focused on the maximisation of utilities and could continuously adjust to altering environments.⁷³ Organisational resources were thus considered to be effectively utilised without people bothering to look inside the box or firm.⁷⁴

Coase developed a theory of the firm that was contrary to the tenets of mainstream literature and focused on relationships within the firm.⁷⁵ He challenged economists and initiated the generation of various theories of the firm.⁷⁶ Oliver Williamson, another economist developed Coases's theory of the firm, stating that the firm could be conceived to be a nexus of incomplete contracts, wherein relationships could be influenced by opportunism.⁷⁷ Such relationships within all probability are based upon asymmetric information, wherein parties possessing informational advantage could exploit others.⁷⁸ Coase stated that apart from usual production costs, it was important to consider transaction costs in explaining the firm.⁷⁹ He stressed upon the comparative transaction costs of structures, like firms and markets.⁸⁰ Oliver Williamson extended this theory, developing it into transaction cost economics.⁸¹ Transaction costs comprise the various costs that take place during the making of an economic transaction.⁸² Extending this concept further it can be said that transaction costs, apart from including bilateral transactions actually subsume contractual relationships that exist between people.⁸³ Such costs symbolise friction losses, namely the resources that are lost for the involved parties but which are essential

⁷² Ménard, C., "The Economics of Hybrid Organizations", *Journal of Institutional and Theoretical Economics*, 160, 3, (2004): 1-32.

⁷³ Madhok, A., "Reassessing the Fundamentals and Beyond: Ronald Coase, the Transaction Cost and Resource-Based Theories of the Firm and the Institutional Structure of Production", *Strategic Management Journal*, 23, 6, (2002): 535-550.

⁷⁴ Granovetter, M.S., "The Impact of Social Structure on Economic Outcomes", *Journal of Economic Perspectives*, 19, 1, (2005): 33-50.

⁷⁵ Coase, R.H., "The Nature of the Firm," *Economica*, 4, (1937): 386-405.

⁷⁶ *Ibid*

⁷⁷ Williamson, O. E., "Markets and Hierarchies: Some Elementary Considerations," *American Economic Review*, 63, 2, (1973): 316-625.

⁷⁸ Williamson, O.E., & Winter, S.G., *The Nature of the Firm: Origins, Evolution, and Development*, (Oxford: Oxford University Press, 1991).

⁷⁹ Coase, R.H., "The Nature of the Firm," *Economica*, 4, (1937): 386-405.

⁸⁰ *Ibid*

⁸¹ Williamson, O. E., "Markets and Hierarchies: Some Elementary Considerations," *American Economic Review*, 63, 2, (1973): 316-625.

⁸² *Ibid*

⁸³ Lazonick, W., *Business Organization and the Myth of the Market Economy*, (Cambridge: Cambridge University Press, 1991).

for reaching specific goals.⁸⁴ Transaction costs in firms can include the expenses of organising business activity over time, planning and strategising for the future and allocating or limiting future risks.⁸⁵ It thus includes various elements of opportunism and uncertainty that are indispensable for debating upon organisational governance.⁸⁶

Williamson stressed that opportunism was an extremely important element of agency theory.⁸⁷ If one of the parties, i.e. the agent has discretion that he is expected to exercise for the advantage of the other, i.e. the principle he may choose to use it for maximising his own utility.⁸⁸ This is bound to result in inefficiencies, wherein the loss to the principal will exceed the advantage reaped by the agent.⁸⁹ If the principal however rewards the agent on a basis that does not correlate his effort to the reward, the agent may not be motivated or incentivised to exercise the required effort.⁹⁰ Such agency problems result in costs that include the loss of possible benefits and the cost of methods that have to be designed to reduce the loss of these possible benefits.⁹¹

Michael Jensen and William Meckling were the first to identify these costs and termed them agency costs.⁹² Economists feel that the special structure of firms creates various forms of opportunism in those who are entrusted with the economic responsibility for the management of the firm.⁹³ Agency theory is essentially based upon the incompleteness of contracts and the separation of ownership, i.e. shareholders and control, namely management.⁹⁴ These are the main characteristics of contemporary corporations including Islamic banks.⁹⁵

⁸⁴ Winter, S.G., "On Coase, Competence, and the Corporation," *Journal of Law, Economics, & Organization*, 4, 1, (1988): 163-180.

⁸⁵ Madhok, A., "Reassessing the Fundamentals and Beyond: Ronald Coase, the Transaction Cost and Resource-Based Theories of the Firm and the Institutional Structure of Production", *Strategic Management Journal*, 23, 6, (2002): 535-550.

⁸⁶ Lazonick, W., *Business Organization and the Myth of the Market Economy*, (Cambridge: Cambridge University Press, 1991).

⁸⁷ Williamson, O. E., "Markets and Hierarchies: Some Elementary Considerations," *American Economic Review*, 63, 2, (1973): 316-625.

⁸⁸ *Ibid*

⁸⁹ Ménard, C., "The Economics of Hybrid Organizations", *Journal of Institutional and Theoretical Economics*, 160, 3, (2004): 1-32.

⁹⁰ Foss, N.J., "Knowledge-Based Approaches to the Theory of the Firm: Some Critical Comments," *Organization Science*, (1996): 470-476.

⁹¹ Williamson, O.E., & Winter, S.G., *The Nature of the Firm: Origins, Evolution, and Development*, (Oxford: Oxford University Press, 1991).

⁹² Jensen, M.C., & Meckling, W.H., "Can the corporation survive", Center for Research in Government Policy and Business, Working Paper no. PPS 76-4, (University of Rochester: Rochester, NY, 1976).

⁹³ *Ibid*

⁹⁴ Mäki, U., "Is Coase a Realist?" *Philosophy of the Social Sciences*, 28, 1, (1998): 5-31.

⁹⁵ *Ibid*

The classical model of the firm assumes that whilst companies are managed by agents, these agents tend to act in the best interest of shareholders.⁹⁶ The owners thus ensure that the agents necessarily act in their interests.⁹⁷ Berle and Means however argued that the interests of shareholders and managers may diverge and that furthermore shareholders may not act as owners, thereby aggravating the agency problem even further.⁹⁸ Whilst the stockholders may want their managers to maximise the value of their shares, the managers may feel it opportune to pursue other strategies.⁹⁹ The law asserts that agents are obliged to serve the interests of their principals but the agents are also likely to serve their personal interest.¹⁰⁰ This concept of agency theory, i.e. the tendency of managers to maximise their own wealth has been proven time and again, especially in the recent financial scandals.¹⁰¹

It however needs to be kept in mind that the agency conflict can be exacerbated by the limited liability of shareholders and their inability to control the management.¹⁰² The concept of limited liability implies that shareholders are only liable to pay up their share capital and whilst they share in organisational profits, they do not take responsibility for losses.¹⁰³ The concept of limited liability thus shifts the risk of business failure from shareholders to creditors.¹⁰⁴ Both the owners and the managers thus have incentives for taking risks as the creditors would suffer most on account of bankruptcies.¹⁰⁵ This in turn could lead to inefficient utilisation of resources.¹⁰⁶

1.4.3 Incentives Theory: Tirole

Jean Tirole is considered to be one of the most influential of contemporary economists.¹⁰⁷ He has truly helped in understanding the ways in which industries can be regulated with a few important firms.¹⁰⁸ Economic theory deals at length with incentives; these include incentives to

⁹⁶ González-Díaz, M., & Vázquez, L., "Make-or-Buy Decisions: A New Institutional Economics Approach," In *New Institutional Economics: A Guidebook*, ed. É. Brousseau and J.-M. Glachant. (Cambridge: Cambridge University Press, 2008).

⁹⁷ *Ibid*

⁹⁸ Berle, A.A., & Means, G.C., *The modern corporation and private property*, (Macmillan: New York, 1932).

⁹⁹ *Ibid*

¹⁰⁰ Lazonick, W., *Business Organization and the Myth of the Market Economy*, (Cambridge: Cambridge University Press, 1991).

¹⁰¹ *Ibid*

¹⁰² Williamson, O.E., & Winter, S.G., *The Nature of the Firm: Origins, Evolution, and Development*, (Oxford: Oxford University Press, 1991).

¹⁰³ Madhok, A., "Reassessing the Fundamentals and Beyond: Ronald Coase, the Transaction Cost and Resource-Based Theories of the Firm and the Institutional Structure of Production", *Strategic Management Journal*, 23, 6, (2002): 535-550.

¹⁰⁴ Mäki, U., "Is Coase a Realist?" *Philosophy of the Social Sciences*, 28, 1, (1998): 5-31.

¹⁰⁵ Winter, S.G., "On Coase, Competence, and the Corporation," *Journal of Law, Economics, & Organization*, 4, 1, (1988): 163-180.

¹⁰⁶ *Ibid*

¹⁰⁷ Tirole, J., *The Theory of Industrial Organization*, (Cambridge: MIT Press, 1988).

¹⁰⁸ *Ibid*

engage in hard work, to produce quality products, to invest, to study and to save.¹⁰⁹ Whilst Adam Smith worked on incentives more than 2 centuries ago in his analysis of share cropping contracts, a theory has emerged in recent decades to place it at the heart of economic thinking.¹¹⁰ Laffont and Tirole developed a synthetic approach on a theory of incentives in procurement and regulation with the focus being on the regulation of natural monopolies, like military contractors, transportation authorities and contractors.¹¹¹ Tirole expanded the concept stating that it has always been difficult to decide on which activities should be operated as public services and which should be left to private firms.¹¹² Several contemporary governments have opened up public monopolies in areas like railways, water, coast, healthcare and schooling to private stakeholders. The experience of such privatisation has been mixed and it has always proved to be somewhat challenging to get private firms to behave in specific ways. There appear to be two challenges in this area. Many markets are dominated by a few businesses that form oligopolies and influence volumes, prices and quality. Regulatory authorities secondly lack information about the costs and the quality of goods and services delivered by these firms, thereby providing them with a natural advantage.

When Tirole published his first work in the 1980s in this area, decision makers advocated simple rules, like capping of prices for monopolists and prohibited cooperative working between competitors for bringing about effective regulation.¹¹³ Tirole's research revealed that such rule were effective in some conditions but brought about significant harm in others.¹¹⁴ Whilst cooperation on price setting was usually harmful, cooperation of pooling of patents could benefit everybody.¹¹⁵ The merger of a firm with its suppliers could distort competition but also result in faster innovation. New theories were needed at that time for oligopoly markets.¹¹⁶ Laffont and Tirole made an important contribution to regulation theory, demonstrating how a set of production contracts could circumvent the challenge of asymmetric information in a market environment where the regulatory authority did not have complete knowledge of the costs and

¹⁰⁹ Dewatripont, M., Rochet, J., & Tirole, J., *Balancing the Banks: Global Lessons from the Financial Crisis*, (Princeton: Princeton University Press, 2010).

¹¹⁰ Smith, A., *The wealth of nation*, Cannan edition, (Modern Library: New York, 1937).

¹¹¹ Laffont, J.-J., & Tirole, J., *A Theory of Incentives in Procurement and Regulation*, (Cambridge: MIT Press, 1993).

¹¹² Tirole, J., *The Theory of Industrial Organization*, (Cambridge: MIT Press, 1988).

¹¹³ *Ibid*

¹¹⁴ Allen, F., Brealey, R., & Myers, S., *Principles of Corporate Finance*, 8th edition, (New York: McGraw-Hill, 2005).

¹¹⁵ Baker, M., & Wurgler, J., "Market timing and capital structure", *Journal of Finance*, 57, (2002): 1–32.

¹¹⁶ *Ibid*

choices of production techniques of a monopolistic company.¹¹⁷ Laffont and Tirole demonstrated that the authority could compensate for its lack of knowledge about the company's condition by allowing it to select from a specific range of cleverly constructed contracts.¹¹⁸ The producer, in such case would choose the correct kind of contract out of self-interest.¹¹⁹ A producer with high costs, which are difficult to control, will choose a contract that provides comparatively high compensation for costs and will thus have scarce motivation to reduce them.¹²⁰ A producer with greater opportunities for cost reduction will choose an arrangement with comparatively low compensation for costs but high prices for service delivery, thereby generating a strong incentive for cost reduction.¹²¹

Laffont and Tirole applied the theory to several issues during the 1980s and 1990s; their publication has greatly influenced regulation in practice.¹²² Several questions have arisen about the time frames of regulation, the period for which the first set of regulation should be prepared and the ways in which it should be reviewed and modified.¹²³ Laffont and Tirole analysed these issues between 1988 and 1990.¹²⁴ They stated that it is assumed that the regulator and the producer cannot enter into a long term contract; only a series of short term contracts is possible.¹²⁵ This implies that the current actions of a producer can affect future regulations.¹²⁶ If a low cost producer engages in hard and focused activity and achieves substantial profits during the initial contract, the regulatory authorities may increase the demand of the next contract in order to lower the profit potential.¹²⁷ This however is open to the risk that the producer will predict the consequences and will work with lesser sincerity, thereby reducing the performance of the business.¹²⁸

When authorities cannot draw up long term contracts, it becomes impossible to get the producers to select the suitable effort at a reasonable cost and thus indirectly reveal cost

¹¹⁷ Laffont, J-J., & Tirole, J., *A Theory of Incentives in Procurement and Regulation*, (Cambridge: MIT Press, 1993).

¹¹⁸ *Ibid*

¹¹⁹ *Ibid*

¹²⁰ *Ibid*

¹²¹ Allen, F., Brealey, R., & Myers, S., *Principles of Corporate Finance*, 8th edition, (New York: McGraw-Hill, 2005).

¹²² Laffont, J-J., & Tirole, J., *A Theory of Incentives in Procurement and Regulation*, (Cambridge: MIT Press, 1993).

¹²³ Dewatripont, M., Rochet, J., & Tirole, J., *Balancing the Banks: Global Lessons from the Financial Crisis*, (Princeton: Princeton University Press, 2010).

¹²⁴ Laffont, J-J., & Tirole, J., *Competition in Telecommunications*, (Cambridge: MIT Press, 1999).

¹²⁵ *Ibid*

¹²⁶ Dewatripont, M., Rochet, J., & Tirole, J., *Balancing the Banks: Global Lessons from the Financial Crisis*, (Princeton: Princeton University Press, 2010).

¹²⁷ *Ibid*

¹²⁸ *Ibid*

conditions.¹²⁹ The authorities should in such case use weaker incentives and progressively learn from these conditions; this will happen swiftly if the business is unprofitable and complex and slowly if it is profitable and simpler.¹³⁰ Weingerg and Wagner stated the companies are like children in a school, with different skills and abilities. Each of them has to be regulated differently because it is motivated by different things.¹³¹ The challenge for regulators is to determine the best incentives for each company and use that knowledge for their effective regulation.¹³² Tirole found that regulators can, by offering a menu of complex and precise options, learn more about the actual incentives at play in the industry being regulated.¹³³ This notion can be applied elsewhere, but within limits.¹³⁴

It is important to keep in mind that the study of regulation was quite rare before Tirole published his first work and was by and large primarily concerned with the ways in which the state could engage in intervention and control crisis in monopoly and perfect competition, the two extreme market structures.¹³⁵ Tirole on the other hand commenced his research with the regulation of oligopoly and the analysis of diverse regulatory industries; he accordingly developed a foundation for a greater and deeper analysis of regulation and market power.¹³⁶ With regard to the financial crisis of 2007-2008, he described it as an effect of weakly implemented regulation, especially in the USA but in Europe as well.¹³⁷ This allowed for the assumption of risk of business entities, which was primarily born by investors and tax payers.¹³⁸ He stated that market and ineffective regulation would not have had such an effect in the surplus liquidity and not encouraged risky behaviour.¹³⁹ He focused on the importance of regulation, as its primary objective was the protection of small depositors, policy holders and pension fund investors.¹⁴⁰ When the country risks the saving of financial mediators, the situation becomes problematic

¹²⁹ *Ibid*

¹³⁰ Baker, M., & Wurgler, J., "Market timing and capital structure", *Journal of Finance*, 57, (2002): 1–32.

¹³¹ Weinberg, D., & Wagner, T., "Explaining the theory that got Jean Tirole his Nobel", (2014), <<http://www.marketplace.org/2014/10/13/economy/explaining-theory-got-jean-tirole-his-nobel>>

¹³² *Ibid*

¹³³ *Ibid*

¹³⁴ Allen, F., Brealey, R., & Myers, S., *Principles of Corporate Finance*, 8th edition, (New York: McGraw-Hill, 2005).

¹³⁵ Fischer, S., "Financial Crises: Review of Eichengreen and Tirole", *Journal of Economic Literature*, 42, 4, (2004): 1094-1097.

¹³⁶ *Ibid*

¹³⁷ *Ibid*

¹³⁸ *Ibid*

¹³⁸ Baker, M., & Wurgler, J., "Market timing and capital structure", *Journal of Finance*, 57, (2002): 1–32.

¹³⁹ *Ibid*

¹⁴⁰ *Ibid*

from the perspective of tax payer protection.¹⁴¹ Another need for regulation stemmed from the need for protection against systemic risk or the domino effect, which in the banking system implied the overflow of risk from one banking institution to another; an event that took place in the financial crisis.¹⁴²

Tirole stated that regulators should pay specific attention to the creation of equal conditions for all market participants in order to refrain from violating the rules of free market competition, a well known dilemma of the banking industry in the late 20th century.¹⁴³ Connecting the concepts of banking deregulation and the financial crisis of 2007-2008, Tirole stated that the policy of ignoring macroeconomic shocks contained in Basel I and Basel II has resulted in substantial intervention in recession and significant leniency in the boom period.¹⁴⁴ With regard to response to a crisis, regulation by and large becomes a necessary practice in all economic segments, especially in the banking sector.¹⁴⁵ Whilst economists and policy makers before Tirole applied similar basic principles of regulation to diverse branches of the economy and the same legal solution for all markets, Tirole showed that the adoption of such practices can give good results in some conditions and to adverse consequences in others.¹⁴⁶ The principles of regulation should thus be carefully applied to all branches of industry after taking account of diverse peculiarities.¹⁴⁷ Tirole's contribution has resulted in the development of a new set of tools that are being used by regulatory and competition protection bodies and can serve as a framework for adaptation of industries like the banking sector, which have strong markets.¹⁴⁸ Tirole's research has played a major role in the investigation of competitiveness and the analysis of various ways for the regulation of the business of large companies.¹⁴⁹

¹⁴¹ Weinberg, D., & Wagner, T., "Explaining the theory that got Jean Tirole his Nobel", (2014), <<http://www.marketplace.org/2014/10/13/economy/explaining-theory-got-jean-tirole-his-nobel>>

¹⁴² *Ibid*

¹⁴³ Fischer, S., "Financial Crises: Review of Eichengreen and Tirole", *Journal of Economic Literature*, 42, 4, (2004): 1094-1097.

¹⁴⁴ Calomiris, C., & Haber, S., *Fragile by Design: Banking Crises, Scarce Credit, and Political Bargains*, (Princeton: Princeton University Press, 2014).

¹⁴⁵ *Ibid*

¹⁴⁶ Besley, Timothy and Case, Ann. "Political Institutions and Policy Choices: Evidence from the United States." *Journal of Economic Literature*, March 2003, 41(1), pp. 7-73.

¹⁴⁷ *Ibid*

¹⁴⁸ *Ibid*

¹⁴⁹ *Ibid*

1.5 Methodology

The formulation of an appropriate research methodology for the preparation of a dissertation constitutes one of the most important elements of the study.¹⁵⁰ Social research is an extremely complex discipline characterised by the presence of different epistemologies, logic, tools and techniques.¹⁵¹ The choice of an inappropriate methodology can thus result in faulty research findings and invalid outcomes.¹⁵²

The research method for this study has been formulated in accordance with the Saunders *et al.*, method, which involves the examination of social research theory in detail, the examination of information sources and finally the choice of the most appropriate research method.¹⁵³

The application of the Saunders method revealed that the objectives of this research project would be best served by the adoption of a, interpretivist / qualitative research approach and the application of the case study method.¹⁵⁴ With the case study method having been subjected to some criticism on account of its focus on few subjects, four cases have been chosen for this project.¹⁵⁵ Efforts have been made to study the application of Islamic banking, with specific regard to home financing in the UK, Sharjah, Saudi Arabia and Dubai. The application of the case study method to four geographies has helped in making the findings far more representative and generalisable and thus useful in arriving at conclusions and making recommendations.¹⁵⁶

1.6 Original Contributions

This research study is interdisciplinary in nature. The study essentially aims to examine Islamic financing in light of the 2016 EU directive for bringing in standardisation and harmonisation across bank lending activities in order to enhance customer security and bring about greater confidence in banking activity. With the credibility of the western banking system being adversely affected on account of the financial crisis and the high level of systemic risks,

¹⁵⁰ Bryman, A., *Social research methods*. 2nd edition, (New York: Oxford University Press, 2004).

¹⁵¹ *Ibid*

¹⁵² *Ibid*

¹⁵³ Saunders, M., Lewis, P., & Thornhill, A., *Research methods for business students*, 4th edition, (London: Prentice Hall, 2007).

¹⁵⁴ Neuman, W. L., *Social research methods, qualitative and quantitative approaches*, 3rd edition, (Boston: Allyn and Bacon, 1997).

¹⁵⁵ Hamel, J., *Case study methods*, (Thousand Oaks: Sage, 1993).

¹⁵⁶ *Ibid*

governments and regulators across the USA, the UK and European countries have been working steadily to introduce measures to reduce systemic risk and enhance the credibility of the banking system.¹⁵⁷ The study thus makes use of several inputs on banking regulation, with especial regard to the regulations that have been introduced after the financial crisis.¹⁵⁸

Islamic banking is essentially a commercial and economic activity, even though its operations are in accordance with the Sharia.¹⁵⁹ Economic theory has developed over the course of the last three centuries in western countries and its tenets are by and large applicable to all types of economic and commercial operations.¹⁶⁰ The research project has thus focused extensively on diverse economic theories that are associated with financing and banking activity.

It also needs to be kept in mind that modern western banking has been strongly affected by recent developments, and especially the creation of novel financial instruments like securitisation, credit derivatives and special purpose vehicles. Information on these issues has thus been included in this research project.

1.7 Conclusions

This introductory section aimed to provide readers with information about various aspects of the research study, with particular regard to the rationale for the research and its aims and objectives. It was pointed out that the range of financial products and Murabaha mortgages being offered by financial institutions in western nations were expanding swiftly.¹⁶¹ It had however also become a matter of concern that lack of standardisation had resulted in the development of mortgages that may or may not be fully compliant with Islamic law; this could have adverse consequences with consumers who may like to invest only in products that were totally compliant with the Sharia and their religious principles.¹⁶² Research on the subject has also

¹⁵⁷ Gupta, A., "Financial crisis enforcing global banking reforms", *Business Strategy Series*, 11, 5, (2010): 286-294.

¹⁵⁸ *Ibid*

¹⁵⁹ Hamoudi, A.H., "Present at the resurrection: Islamic finance and Islamic law", *American University International Law Review*, 26, 4, (2011): 1107-1123.

¹⁶⁰ Kara, A., Marques-Ibanez, D., & Ongena, S., "Securitization and lending standards: Evidence from the wholesale loan market", (2010),

<https://www.ecb.europa.eu/events/conferences/shared/pdf/Securitisation_and_lending_standards.pdf?ad13e1fd6809d13f369a6c84e9f4d48http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf<https://www.ucm.es/data/cont/media/www/pag-41460/Minsky%20theory%20of%20financial%20crisis.pdf><http://www.economicshelp.org/blog/6864/economics/financial-instability-hypothesis/>>

¹⁶¹ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

¹⁶² *Ibid*

revealed that the area of Islamic banking, including procedures for home financing through Murabaha were adversely affected on account of lack of standardisation and differences in the policies and procedures followed by different banks. It was thus important to determine the degree to which various Islamic products on offer were actually compliant with Sharia.¹⁶³ Research also revealed that complete Sharia compliance was certainly not the norm in the Islamic Murabaha products that were on offer in the market.¹⁶⁴ This study thus primarily aimed to assess and determine the extent to which Islamic products in various markets across the world complied with Islamic laws.¹⁶⁵ Whilst this thesis aims to primarily deal with the important elements of Murabaha mortgage contracts, it aims to specifically assess the extent to which they are compliant with existing Islamic laws.¹⁶⁶ The research project will also aim to examine the level to which mortgages issued under Islamic finance were associated with socio economic advantages, compared to commercial banks.¹⁶⁷ This section provides basic information about the research method followed for the purpose of this study. The dissertation has made use of a qualitative approach and the application of the case study method to the application of Islamic banking to the four chosen geographies, i.e. the UK, Sharjah, Saudi Arabia and Dubai. The use of four case studies has helped in the conduct of holistic, multidimensional and in-depth research on the subject, as well as on enhancing generalisability and representativeness of the findings.

The introductory section also contains the critical theoretical framework for the study. This theoretical framework makes use of various aspects of modern financial theory and orthodox economics; it has taken up the contents of the Turner Review and examined various aspects of orthodox financial theory, like the capital asset pricing model, the Modigliani Miller capital structure, Keynesian economics, Neo-classical economic theory and the new classical school. Attention has also been paid to the arguments set forward by Coase, Williamson, Jensen and Meckling, Incentives theory, arguments in order to develop a comprehensive and holistic understanding of the subject. The next section contains a comprehensive review of literature on various aspects of the research subject in far greater detail.

¹⁶³ *Ibid*

¹⁶⁴ Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, 39, (2010): pp. 36-45.

¹⁶⁵ *Ibid*

¹⁶⁶ Aldohni, A.K., *The legal and regulatory aspects of Islamic banking*, (London: Routledge Publishers, 2012).

¹⁶⁷ *Ibid*

1.8 Outline of Thesis

Chapter One sets out the research question relating to how the Saudi mortgage market may be developed given a critical review of the theories of modern micro and macro-economic, socio-economic and financial economic theories of agency, contracts, incentives, risk, and the complexity of market systems. These modern theories of finance and contemporary economic risk and incentive theory have been indicted in the support of the excesses and abuses found in the Credit Crisis of 2007-08. This critical view of the technical theoretical foundations of Western secular financial economics will be sharply contrasted in later Chapters to the religious doctrines and ethical aims of Islamic finance. This chapter includes the development of a research question and information on the development on the research question and provides details about the central argument of the thesis. It has been stated that Islamic finance and banking practices suffer from two specific inadequacies, namely a marked lack of standardisation between the banking policies and practices followed by different banks and the possibility of lack of Sharia compliance in some of the banks. These features of Islamic banking have resulted in some significant weaknesses in the provisioning of banking services. The possibility of inadequate Sharia compliance has the potential of disturbing a specific segment of customers who wish to engage in banking activities that are carried out in accordance with Islamic religious laws and tenets. The lack of standardisation amongst the tenets offered by different banks can also result in significant confusion in the minds of customers. Attention to these issues can thus enhance the viability of Islamic banking operations, especially in sizeable western markets that are as of now dominated by conventional western banks. Aligned to this broad yet specific analysis of socio-legal relations is the concept of market discipline and governance which have been heavily promoted by Central Banks for the control of market behaviours. Again, this imposition of what may be considered normative behaviours on market players in finance finds a resemblance in what Islamic finance aims to do from its origins.

Chapter Two of the thesis consists of a detailed overview of the methodology that will be implemented in order to achieve the aims and objectives of the thesis. In particular, it will provide a detailed overview and a justification of the decision to utilise a comparative methodology based on socio-economic principles of agency theory as espoused by Jensen and Meckling and the advantage and disadvantages that are associated with the selection of case

studies as the research methodology. The chapter will discuss the methods that were used to analyse the results of the case study, how the researcher ensured that the relevant ethical considerations were catered for within the research, and the extent to which various limitations associated with the research methodology might limit the usefulness of the research conducted within this thesis.

Chapter Three of the thesis consists of the Literature Review – this comprises a detailed, critical review of the existing literature that has been conducted into the extent to which the Islamic mortgages which are provided by financial institutions within the UK are actually compliant with *Sharia* principles. This will also consist of a detailed analysis of the existing legislative framework concerning the provision of home financing packages within UK law, and the extent to which the more rigorous definition of what constitutes *Sharia* compliance may be restricted by the UK's legislative system. This will be supplemented by an analysis of the provision of Islamic financial products to Muslim consumers within the US. This chapter will also be accompanied by a discussion of the existing gaps in the research literature, and the extent to which this gap in the research will be addressed within the existing thesis.

Chapter Four of the thesis consists of the contents of the case studies conducted into the provisions of Islamic mortgages within a variety of different countries. The key case studies will focus primarily on the UK, and secondarily, on other European countries, all of which have sizeable Muslim populations and which offer the comprehensive range of Islamic financial products among non-Islamic countries. There are also case studies of Saudi, Sharjah and Dubai in order to contextualise the differences in the socio-economic patterns with regard to Islamic financial products. The aim of these case studies will be to determine the extent to which the home financing packages which are offered by Islamic financial institutions within a range of countries are actually compliant with *Sharia* principles, and the extent to which full compliance with *Sharia* law is possible, given the existing legislative system of that country.

Chapter Five of the thesis consists of the recommendations made, on the ways in which Islamic financial products that are on offer within the countries featured in the case studies, i.e., Saudi, Sharjah and Dubai, and within the UK in particular, can be made to more rigorously comply with *Sharia* principles. This will be a useful way of commenting on how various legislative factors, and also the need to compete successfully with their conventional

counterparts, may limit the extent to which greater *Sharia* compliance on the part of financial institutions is possible.

Chapter Six of the thesis consists of the conclusion to the research. It comprises a summary of the key findings that have been made together with a reflection on the extent to which the findings have been successful at meeting the aforementioned aims and objectives. This will be accompanied with a discussion of the extent to which the limitations of the research may have restricted the extent to which the research conducted in the thesis is useful and generalisable. Finally, the researcher will make certain recommendations on the way in which the research methodology could be adapted in future in order to increase the effectiveness of the research, as well as outlining further avenues of research that have arisen as a result of this thesis, and which could be pursued in the future.

Chapter 2: Research Method

2.1 Introduction

This chapter of the research study elaborates upon the adoption of a specific research method and the reasons for doing so. The chapter is sequentially structured. This section provides details about the individual sections in this chapter and the broad method followed for the formulation of the research approach. The second section elaborates upon the interdisciplinary approach to the study. The third section identifies the research methodology; the fourth section provides details about the research design. The fifth and sixth sections provide information about the research design and the research strategy. The seventh section provides information about the research process.

The formulation of an appropriate research method is one of the most important elements in the conduct of a meaningful research study.¹⁶⁸ Social research has been informed by several

¹⁶⁸ Boland, R.J., *Phenomenology: a preferred approach to research on information systems*. In: *Research methods in information systems*, (Amsterdam: North-Holland, 1985).

research theories and has been influenced and shaped by distinct epistemologies, logical approaches, theories, tools and techniques.¹⁶⁹ With such an extensive range of approaches available to researchers, it often becomes difficult for them to choose the most appropriate one for a particular study.¹⁷⁰ Social researchers must thus examine the needs of a research study, match it with their knowledge of social research theory and choose the most appropriate research approach.¹⁷¹ The adoption of an appropriate research method commences with the formulation of appropriate research questions.¹⁷² The research questions for this study have already been elaborated in the introductory section of this paper.

Saunders *et al.*, stated that the choice of an appropriate research method should be carried out in a systematic and stage wise manner involving the study of research theory, the examination of the needs of particular research project, the choice of the most suitable research approach, the selection of information sources, the procedure for collection and analysis of data and the laying down of the ethical norms and standards required for the project.¹⁷³ The Saunders Onion illustrates the various aspects of social research that need to be considered by a researcher in the course of design of a research approach.¹⁷⁴

Chart 1: Saunders Research Onion¹⁷⁵

¹⁶⁹*Ibid*

¹⁷⁰*Ibid*

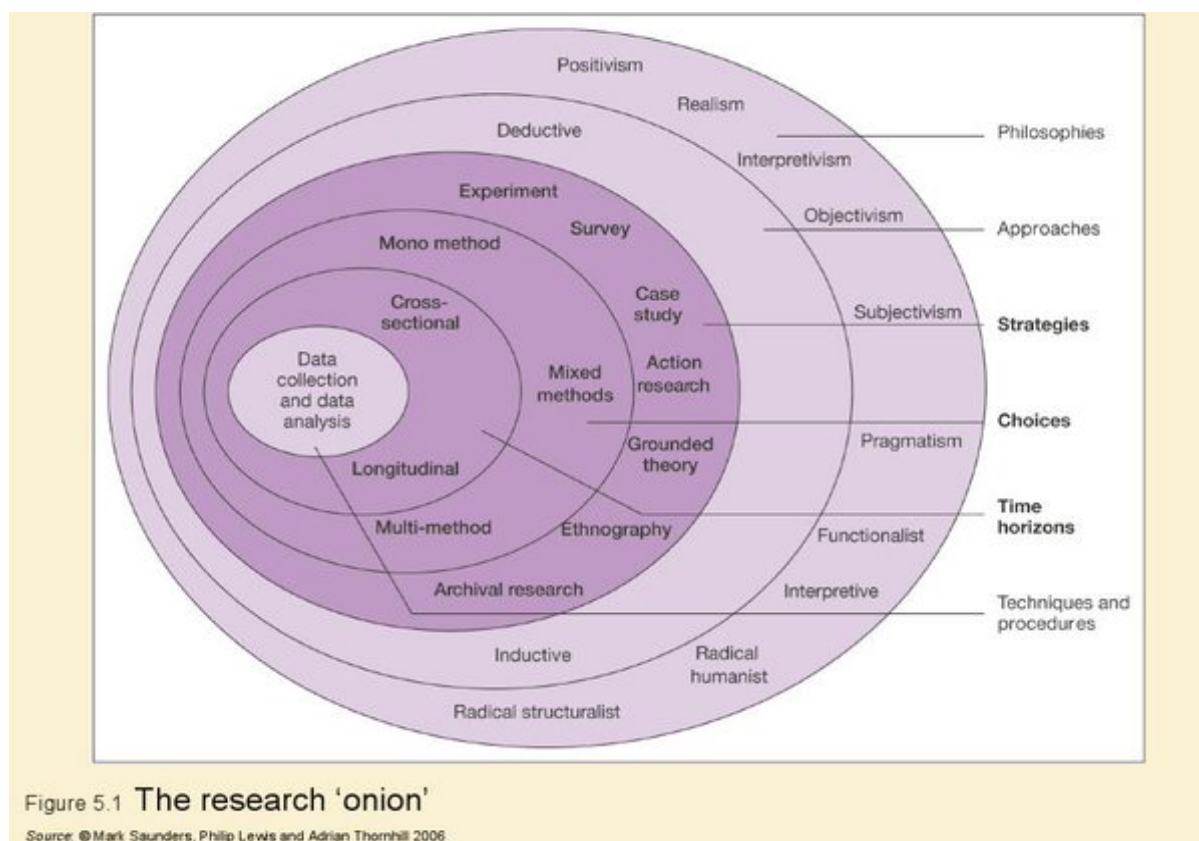
¹⁷¹ Bryman, A., *Social research methods*, (Oxford: Oxford University Press, 2008).

¹⁷²*Ibid*

¹⁷³ Saunders, M., Lewis, P., & Thornhill, A., *Research methods for business students*, 4th edition, (London: Prentice Hall, 2007).

¹⁷⁴*Ibid*

¹⁷⁵*Ibid*



2.2 Interdisciplinary Nature of the Research Study

This dissertation makes use of an interdisciplinary approach in order to develop a holistic and multidimensional approach to the investigation. Interdisciplinary research comprises a specific mode of investigation that integrates information and data from two or more disciplines in order to increase the fundamental understanding of the subject and arrive at in-depth findings.¹⁷⁶ The interdisciplinary approach is being increasingly used by modern researchers on account of its benefits in enhancement of understanding by making use of different disciplines in order to generate comprehensive understanding about the research subject.¹⁷⁷ Whilst the approach has been critiqued on account of its potential for creation of confusion and requirement of substantially greater time, its use in the development of higher order thinking skills and the

¹⁷⁶ Ausburg, T., *Becoming Interdisciplinary: An Introduction to Interdisciplinary Studies*, 2nd edition (New York: Kendall/Hunt Publishing, 2006).

¹⁷⁷ *Ibid*

integration of pedagogy has made it increasingly used.¹⁷⁸ Thompson stated that its application helps in discovery and innovation.¹⁷⁹

This particular study focuses on the various measures that can be brought about to enhance Sharia compliance, harmonisation and standardisation in Islamic banking practices, with specific regard to home mortgage financing. Thompson stated that the adoption of interdisciplinary research can help in the achievement of specific outcomes, namely the development of provider audience, better explanatory and predictive work, improved normative work, inspiration to confront questions that would have not otherwise occurred and act in opposition to the unhealthy practice of hyper specialisation that is becoming increasingly common in contemporary academic work.¹⁸⁰

2.3 Identification of Research Methodology

The research methodology for this dissertation makes use of interpretivism, inductive logic and qualitative tools and techniques. It is widely acknowledged that the interpretivist / qualitative approach are most appropriate for the conduct of complex, multi-layered and multifaceted projects.¹⁸¹ The adoption of an interpretivist / qualitative approach helps in the use of exploratory methods, the utilisation of narratives and the application of interpretation to complex research issues.¹⁸² This dissertation makes use of the case study approach, which is being increasingly used by modern researchers who wish to obtain multidimensional perspectives of the research subject. The design for this research study has been formulated, in accordance with Saunders *et al.*, Onion Model, which involves the exhaustive study of existing social research approaches, followed by the choice of the one considered to be most appropriate for this project.¹⁸³ The following subsections briefly deal with (1) positivism and interpretivism, (2) deductive and inductive logic, (3) quantitative and qualitative techniques, (4) primary and secondary information sources and (5) the mixed method model of research. The examination of these issues has helped in the subsequent development of research strategy and method.

¹⁷⁸ *Ibid*

¹⁷⁹ Thompson, K.J., *Interdisciplinarity: History, Theory, and Practice*, (Detroit: Wayne State University, 1990).

¹⁸⁰ *Ibid*

¹⁸¹ Creswell, J.W., *Research design: qualitative, quantitative, and mixed methods approaches*, (London: Sage Publications, 2009).

¹⁸² *Ibid*

¹⁸³ Saunders, M., Lewis, P., & Thornhill, A., *Research methods for business students*, 4th edition, (London: Prentice Hall, 2007).

2.4 Research Design

The research design of a dissertation is concerned with the overall strategy chosen by the researcher to integrate the different elements of the study in a coherent, rational and logical manner, which can consequently help in addressing the research problem.¹⁸⁴ The research design for this study has been formulated after the study of social research theory and aligning the same with the needs, aims and objectives of this particular study.¹⁸⁵ As elaborated in the earlier subsection, the research for this project involves the application of the interpretivist / qualitative approach. The design entails the conduct of a detailed literature review on various aspects of the research issue and the conduct of qualitative study on the application of Islamic finance and banking, with special regard to Murabaha financing, in four specific geographies, namely the United Kingdom, Sharjah, Saudi Arabia and Dubai.

Information for this research has been obtained from numerous information sources, especially governmental websites, research studies and journal publications. Efforts have been made to ensure that the information sources are current and not obsolete. The information sources have also been scrutinised to ensure their reliability and relevance for this particular study. The information obtained has been carefully collated and arranged in order to facilitate thematic analysis. The themes for analysis have been determined in accordance with the research questions of the dissertation.

The conduct of the thematic analysis has resulted in specific outcomes, which have been detailed in the concluding section.

2.5 Research Strategy

The formulation of an appropriate research strategy involves the examination of social research theory and the adoption of the most appropriate theoretical and analytical approach. This section provides details about the important elements of social research theory followed by the formulation of an appropriate research strategy for this dissertation.

¹⁸⁴Neuman, W. L., *Social research methods, qualitative and quantitative approaches*, 3rd edition, (Boston: Allyn and Bacon, 1997).

¹⁸⁵*Ibid*

It is important to begin this section with an overview of social research philosophy / theory. Social research philosophy has been shaped by two specific and distinct theoretical approaches, namely the positivist and interpretivist approaches to social research.¹⁸⁶ These basic research approaches have been augmented by appropriate logical approaches, appropriate tools and techniques for the conduct of research and processes for the choice of the most appropriate information sources.¹⁸⁷ Social researchers must also adhere to specific ethical norms and standards in order to maintain the sanctity and worth of social research.¹⁸⁸

2.5.1 Positivism and Interpretivism

Social research philosophy has essentially been influenced by two contrasting epistemologies, i.e. positivism and Interpretivism.¹⁸⁹ The positivist approach, which has been derived from scientific research, is essentially rational and objective in its approach.¹⁹⁰ It specifies that social research, if it has to be meaningful, must, like scientific research be based upon the physical or sensory observation of social research subjects.¹⁹¹ Such observation of research phenomena or subjects should be carefully and systematically detailed and thereafter analysed in detail with appropriate and established numerical / statistical tools to arrive at valid outcomes.¹⁹² Advocates of positivism specifically decry the use of subjectivity or unfounded interpretation in the process of arriving at appropriate, valid and generalisable outcomes.¹⁹³

Interpretivism, which developed in reaction to the rather narrowly focused and stern approach of positivism stated that social research was essentially too complex an activity for its need to be met by positivist ways of conducting research.¹⁹⁴ Advocates of Interpretivism state that most social research subjects, involved as they are with the thoughts and actions of often irrational and illogical humans are too complex multidimensional and multi-layered to be handled with simplistic and linear positivist approaches.¹⁹⁵ Advocates of Interpretivism assert that whilst the use of numerical research approaches results in the obtaining of useful

¹⁸⁶ Cohen, M.L., & Morrison, K., *Research Methods in Education*, 7th edition, (London: Routledge, 2011).

¹⁸⁷ *Ibid*

¹⁸⁸ Creswell, J.W., *Research design: qualitative, quantitative, and mixed method approaches*, (London: SAGE, 2003).

¹⁸⁹ Hayes, N., *Doing psychological research: gathering and analysing data*, (NY: Open University Press, 2000).

¹⁹⁰ *Ibid*

¹⁹¹ Creswell, J.W., *Research design: qualitative, quantitative, and mixed methods approaches*, (London: Sage Publications, 2009).

¹⁹² *Ibid*

¹⁹³ *Ibid*

¹⁹⁴ Hatch, J.A., *Doing qualitative research in education settings*, (NY: SUNY Press, 2002).

¹⁹⁵ *Ibid*

information, the conduct of research projects would by and large entail the application of more exploratory research tools.¹⁹⁶ They added that the conduct of complex research study with only positivist approaches could, on occasion, even result in trite outcomes.¹⁹⁷

Interpretivism, it needs to be pointed out emerged as a critique of positivism and the appreciation that human behaviour can very rarely be explained through arithmetic and quantification and that sociology was nearer the liberal arts than it was to science. Interpretivism makes the point that human beings cannot be considered to be similar puppets and do not react to stimuli in a generalised and similar manner. They are on the contrary, active, distinct, and purposeful and react to stimuli in diverse ways, which again fundamentally depends upon their individual interpretation of such stimuli. Advocates of Interpretivism assert that human beings have the ability, the power and the intention to interpret as also the capability for developing, constructing and building their surroundings; they prefer to think and act on their own, rather than exist as viewers to the happenings around them.

Interpretivism does not diminish scientific knowledge but questions its utility in examination of multidimensional social research issues. It states that social and business issues and developments should be examined in a multidimensional and holistic manner, which is not possible with a positivist approach to study. This can lead to the overlooking of significant features. Interpretivism suggests that humans are complex and multifaceted; it would thus be inappropriate to investigate, analyse and assess them only with numbers, figures and statistics.

Black stated that interpretivists avoid rigid structural frameworks, as is done in positivist research and adopt more flexible and personal research structures that are directed towards the capturing of meaning in human interaction and make sense of what is perceived as reality.¹⁹⁸ They perceive the researcher and the researcher's informants to be mutually interactive and interdependent.¹⁹⁹ The interpretivist researcher engages in research with some element of prior insight of the research context but assumes that this is likely to be inadequate in the development of a fixed research design on account of complex, multiple and unpredictable character of what can be perceived as true reality.²⁰⁰ The researcher remains open to new knowledge throughout

¹⁹⁶ Denscombe, M., *The Good Research Guide: For Small-scale Social Research Projects*, (NY: McGraw-Hill, 2010).

¹⁹⁷ *Ibid*

¹⁹⁸ Black, I. The presentation of interpretivist research. *Qualitative Market Research: An International Journal*, 9, 4 (2006): 319–324.

¹⁹⁹ *Ibid*

²⁰⁰ *Ibid*

the study and thus lets it develop with the assistance of informants.²⁰¹ The application of such an emergent and collaborative approach is consistent with the belief that individuals have the ability for adaptation and it is not possible to obtain prior information and knowledge of context and time bound social realities.²⁰² The goal of interpretivist research is thus to understand and interpret meanings in human behaviour rather than to engage in generalisation and predict cause and effect.²⁰³ It is important for an interpretivist researcher to understand motives, reasons, meanings and other subjective experiences that are bound by context and time.²⁰⁴ Interpretivist research is based on relativist ontology and subjectivist or transactional epistemology. Carson *et al.*, stated that the use of the interpretivist approach in business studies involves the following principles.²⁰⁵

- The Fundamental Principle of the Hermeneutic Circle
- The Principle of Contextualisation
- The Principle of Generalisation and Abstraction
- The Principle of Interaction between Researchers and Subjects
- The Principle of Dialogical Reasoning
- Principle of Multiple Interpretations
- The Principle of Suspicion

The following table details the ontological, epistemological and methodical differences between positivism and interpretivism.

Table 1: Ontological, Epistemological and Methodical Differences between Positivism and Interpretivism²⁰⁶

Ontology	Positivist	Interpretivist
Nature of 'being'/ nature of the world	Have direct access to real world	No direct access to real world
Reality	Single external reality	No single external reality

²⁰¹ *Ibid*

²⁰² Carson, D., Gilmore, A., Perry, C., & Gronhaug, K. *Qualitative Marketing Research*. (London: Sage, 2001).

²⁰³ Black, I. The presentation of interpretivist research. *Qualitative Market Research: An International Journal*, 9, 4 (2006): 319–324.

²⁰⁴ *Ibid*

²⁰⁵ Carson, D., Gilmore, A., Perry, C., & Gronhaug, K. *Qualitative Marketing Research*. (London: Sage, 2001).

²⁰⁶ *Ibid*

Epistemology		
'Grounds' of knowledge/ relationship between reality and research	Possible to obtain hard, secure objective knowledge Research focus on generalization and abstraction Thought governed by hypotheses and stated theories	Understood through 'perceived' knowledge Research focuses on the specific and concrete Seeking to understand specific context
Methodology		
Focus of research Role of the researcher	Concentrates on description and explanation Detached, external observer Clear distinction between reason and feeling Aim to discover external reality rather than creating the object of study Strive to use rational, consistent, verbal, logical approach Seek to maintain clear distinction between facts and value judgments Distinction between science and personal experience	Concentrates on understanding and interpretation Researchers want to experience what they are studying Allow feeling and reason to govern actions Partially create what is studied, the meaning of phenomena Use of pre-understanding is important Distinction between facts and value judgments less clear Accept influence from both science and personal experience

Techniques used by researcher	Formalized statistical and mathematical methods predominant	Primarily non-quantitative
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2.5.2 **Inductive and Deductive Logic**

The two broad methods of reasoning in logic are known as the deductive and inductive approaches.²⁰⁷ Deductive reasoning, which is essentially associated with positivist research commences with general reasoning and then works its way down to the more specific.²⁰⁸ Such an approach, which is informally known as the top down approach commences with the generation of a theory about the researcher's subject.²⁰⁹ This is thereafter narrowed down to specific and particular hypotheses that are capable of being tested.²¹⁰ Observations are thereafter collected to test such hypotheses.²¹¹

Inductive reasoning works contrary to deductive logic and moves from specific observation in an exploratory and informal manner to broader and more general hypothesis.²¹² Termed the bottom up approach, inductive reasoning commences with the generation of specific observations and measures, followed by the detection of regularities and patterns, the formulation of tentative hypotheses and finally to the development of generalisable theories or conclusions.²¹³ Deductive reasoning is narrower than inductive logic and is essentially concerned with the testing or confirmation of hypothesis.²¹⁴ Inductive reasoning on the other hand is more open ended and exploratory and is thus frequently used in interpretivist research for the generation of hypothesis.²¹⁵

This research study is essentially exploratory in nature and deals with the identification of the ways in which Islamic banking procedures can be modified to bring about greater Sharia compliance, standardisation and harmonisation. An exploratory and open ended inductive

²⁰⁷ Strauss, A.L., & Corbin, J.M., *Basics of qualitative research: grounded theory procedures and techniques*, (NY: Sage Publications, 1990).

²⁰⁸ *Ibid*

²⁰⁹ *Ibid*

²¹⁰ *Ibid*

²¹¹ *Ibid*

²¹² Babbie, E., *The practice of social research*, 9th edition, (NY: Belmont: Wadsworth, 2001).

²¹³ *Ibid*

²¹⁴ Bryman, A., *Social research methods*. 2nd edition, (New York: Oxford University Press, 2004).

²¹⁵ *Ibid*

approach has been used to develop the main research question and the subsidiary research questions have flowed from the main one. The research approach is thus bottom-up and makes use of the information available in the public domain to explore and determine the most appropriate ways in which existing Islamic banking procedures can be suitably modified to make it beneficial for fund providers and users and to enlarge Islamic mortgage markets. The study of Islamic banking in Saudi Arabia, for example has been carried out through the exploration of Saudi mortgage legislation, the understanding of the benefits of the new legislation and the possible impact of the law in various areas dealing with the creation of mortgages and the motivation of providers and users of funds. The Sharia implications of mortgage based transactions have also been explored in detail.

2.5.3 Quantitative and Qualitative Techniques

The increasing use of both positivist and interpretivist tools has resulted in the development of specific and specialised tools and techniques for the conduct of research assignment.²¹⁶ These tools and techniques can be grouped into two categories, namely (1) quantitative tools, which are by and large used for the furtherance of positivist approaches and (2) qualitative techniques, which are utilised when researchers make use of interpretivist social research approaches.²¹⁷ The goal in the conduct of quantitative research is by and large the determination of the relationship between an independent and a dependent variable within a population.²¹⁸ Quantitative research design is either descriptive or experimental. A descriptive study establishes association between variables, whereas an experimental study establishes causality.²¹⁹ Quantitative research essentially deals in number and logic and adopts an objective stance.²²⁰ It focuses on numeric and unchanging data and reasoning that is detailed and convergent rather than divergent.²²¹ The data in quantitative research is gathered with the help of structured research instrument.²²² The results are based upon larger sample sizes that are by and

²¹⁶ Brannen, J., Combining qualitative and quantitative approaches: an overview. In Julia Brannen (Ed.), *Mixing methods: qualitative and quantitative research*, (Brookfield: Avebury, 1992).

²¹⁷ Hayes, N., *Doing qualitative analysis in psychology*, (NY: Psychology Press, 1997).

²¹⁸ *Ibid*

²¹⁹ *Ibid*

²²⁰ Coffey, A., & Atkinson, P., *Making sense of qualitative data: complementary research strategies*, (London: Sage Publications, 1996).

²²¹ *Ibid*

²²² Cassell, C., & Symon, G., *Qualitative methods in organizational research: a practical guide*, (London: Sage, 1994).

large representative of the population.²²³ Hayes stated that quantitative research can by and large be repeated or replicated, given its high level of reliability.²²⁴

Qualitative research on the other hand is used when social researchers make use of interpretivist methods.²²⁵ Such research makes use of diverse tools and techniques that are often open ended and exploratory in nature.²²⁶ The research tools are essentially designed to ensure that research subjects are investigated from multiple dimensions in order to obtain in-depth results.²²⁷ Qualitative research by and large makes use of smaller samples because the research effort by itself is more complex and time consuming than quantitative study.²²⁸ Social researchers make use of diverse tools and techniques, including thematic analysis, content analysis and case study analysis to arrive at valid and in-depth outcomes.²²⁹ The following table provides the distinguishing features of quantitative and qualitative research.²³⁰

It is relevant at this point to discuss the advantages and limitations of qualitative research.

2.5.3.1. Advantages of Qualitative Research

Qualitative research is associated with certain specific benefits, which are detailed below.

- Subject materials can be assessed and evaluated in greater detail: Qualitative research focuses less on the metrics of the collected data and more on the various subtleties of what can be derived from the information. This can provide more opportunities for obtaining insights.²³¹
- Qualitative research frameworks are fluid and based upon incoming data: Qualitative research adapts to the quality of gathered information and can seek to gather data in a new direction. This results in greater opportunities to gather information about the subject and results in freedom from limited perspectives.²³²

²²³ *Ibid*

²²⁴ Hayes, N., *Doing qualitative analysis in psychology*, (NY: Psychology Press, 1997).

²²⁵ Miles, M.B., & Huberman, A.M., *Qualitative data analysis: an expanded sourcebook*, (London: Sage Publications, 1994).

²²⁶ *Ibid*

²²⁷ *Ibid*

²²⁸ Patton, M.Q., *Qualitative research and evaluation methods*, 3rd edition, (California: SAGE, 2002).

²²⁹ *Ibid*

²³⁰ *Ibid*

²³¹ Saunders, M., Lewis, P., & Thornhill, A., *Research methods for business students*, 4th edition, (London: Prentice Hall, 2007).

²³² *Ibid*

- Qualitative research data is based upon experiences and operations: qualitative data does not ignore the instinctual nature of the human mind; it embraces it, which in turn often results in better collection of data.²³³
- Qualitative data is characterised by a predictive quality: The gathered individualistic data in qualitative research often has a predictive quality for the individual from whom it was gathered.²³⁴
- Qualitative research frequently operates within fluid structures: Experienced researchers in qualitative research can follow up interesting answers with further questions. They can follow data tangents and enhance the overall information database collected through the process.²³⁵
- Data complexities can be integrated and incorporated into generated conclusions: It is not possible to remove human experiences from research processes because unique experiences generate distinctive perspectives of the perceived data. Such complexities, when gathered into singular databases can generate conclusions with greater accuracy and depth with consequent benefits.²³⁶
- Qualitative research is open ended in character: The open ended structure of qualitative research enables the researcher to go beneath superficial responses and rational thought in order to obtain information from the emotional responses of individuals. This is vitally important because emotional responses frequently influence the behaviour and drive the decision of individuals.²³⁷
- Creativity, in qualitative research, is a desirable quality: The application of the qualitative research method makes it possible for individuals to encourage respondent creativity and enables people to express themselves with genuineness and authenticity. This results in greater accuracy of collected data and can result in predictable outcomes.²³⁸

²³³ *Ibid*

²³⁴ Boyatzis, R.E., *Transforming qualitative information: thematic analysis and code development*, London: Sage Publications, 1998).

²³⁵ Bogdan, R., & Biklen, S.K., *Qualitative research for education: an introduction to theory and methods*, (Pearson/Allyn and Bacon, 2007).

²³⁶ Hayes, N., *Doing qualitative analysis in psychology*, (NY: Psychology Press, 1997).

²³⁷ Bogdan, R., & Biklen, S.K., *Qualitative research for education: an introduction to theory and methods*, (Pearson/Allyn and Bacon, 2007).

²³⁸ Boyatzis, R.E., *Transforming qualitative information: thematic analysis and code development*, London: Sage Publications, 1998).

- Brands and businesses currently need to build relationships with their core demographic for survival: Miscommunication can arise when there is difference in context between two types of communication. Qualitative research provides brands with access to these insights in order to ensure that they can communicate their value proposition accurately.²³⁹
- The use of smaller sample sizes can save on time and costs: Some qualitative research projects can be achieved swiftly and on limited budget because of their use of smaller sample sizes; this allows for faster and accurate outcomes.²⁴⁰
- Attitude explanations are possible with qualitative research: Qualitative research helps in the achievement of a greater understanding of consumer attitudes, which provides an explanation for occurrences that take place outside the predictive matrix.²⁴¹

2.5.3.2. Disadvantages of Qualitative Research

_____ Notwithstanding the several advantages of qualitative research, it is also associated with some limitations, which need to be recognised by researchers and considered in the development of the research process.²⁴² These disadvantages are detailed below.

- The quality of information obtained in qualitative research is likely to be subjective: The personal nature of obtaining information in qualitative research can sometimes turn over to be a negative element of the process. Whilst the presence of individual perspectives and the inclusion of instinctive decision can result in very detailed data, it can also result in data that is generalised or possibly even inaccurate because of the subjectivity of the researcher.²⁴³
- It is more difficult to assess and demonstrate data rigidity in qualitative research: There is little doubt that individual perspectives frequently form the basis of the data that is obtained in qualitative research, which makes it difficult to ensure

²³⁹ *Ibid*

²⁴⁰ Bogdan, R., & Biklen, S.K., *Qualitative research for education: an introduction to theory and methods*, (Pearson/Allyn and Bacon, 2007).

²⁴¹ *Ibid*

²⁴² Bryman, A., *Social research methods*. 2nd edition, (New York: Oxford University Press, 2004).

²⁴³ *Ibid*

rigidity in collected information. The subjective nature of the data collection process makes it challenging for researchers to demonstrate data validity.²⁴⁴

- The mining of information through qualitative research can frequently be time consuming: The amount of detail collected through the performance of qualitative research is frequently substantial. The sorting of such data to pull out the key information points can not only be time consuming but also subjective because what is considered important by one researcher may not be important for another. Data mining of substantial amount of data can often take substantial time and effort.²⁴⁵
- The conduct of qualitative research results in findings that are valuable but not simple to present: The subjective nature of information obtained through qualitative research can make findings from qualitative research very challenging to present. The insights obtained by a researcher from the data can thus be very different from that of an outside observer.²⁴⁶
- The data obtained through qualitative research may not always be accepted: The scientific community may not sometimes accept the data collected through qualitative research because of its subjective nature. The commencement of the process of community acceptance thus often calls for the conduct of a second independent qualitative research effort with similar findings.²⁴⁷
- The influence of the researcher in qualitative research can have a negative effect on the collected information: There is little doubt that the quality of data collected through qualitative research is overly dependent on the observation and skills of the researcher. The perspectives of researchers with biased viewpoints can thus be included in the collected data and influence outcomes. It is thus necessary to build in controls in order to remove the potential for bias and ensure that the collected information can be reviewed and assessed with integrity.²⁴⁸
- The replication of results can sometimes be difficult with qualitative research: The scientific community wishes to see results, which can be duplicated and

²⁴⁴ *Ibid*

²⁴⁵ Hayes, N., *Doing qualitative analysis in psychology*, (NY: Psychology Press, 1997).

²⁴⁶ *Ibid*

²⁴⁷ Hatch, J.A., *Doing qualitative research in education settings*, (NY: SUNY Press, 2002).

²⁴⁸ *Ibid*

verified. This can be extremely difficult in qualitative research because of the variability of researcher bias but also the informational bias that is incorporated in the data from the provider. The scope of the information gathering can be limited on account of unique perspectives.²⁴⁹

- Difficult decisions can call for repetitive qualitative research serious: Whilst the smaller sample sizes in qualitative research may enhance convenience, they are not always representative of larger population demographics. This may necessitate follow-up with a greater quantitative sample in order to track data points with greater accuracy.²⁵⁰
- Qualitative research is not statistically representative: One of the biggest disadvantages of qualitative research is its lack of statistical representation. With qualitative research being a perspective based method, responses provided are not measured. Quantitative data is required for circumstances that need statistical representation, which is not part of the qualitative process.²⁵¹

The following table has been developed from Patton’s book on qualitative research and evaluation method.

Table 2: Distinguishing Features of Quantitative and Qualitative Research²⁵²

Qualitative	Quantitative
All investigation is essentially qualitative in nature	Data cannot be qualitative; it has to be in numbers
Focuses on details and description	Focuses on classification and counting of features and construction of statistical models
Researcher has rough idea of what is being looked for	Researcher is aware of what is being investigated
Useful in early stages of research	Research design is created before collection of data
Unfolding of story results in emergence of design	Specific tools are used to collect data
Researcher obtains data for himself or herself	Data is numerical or statistical in nature
Information can be in words, illustrations and	Focus is on exact measurement and

²⁴⁹ *Ibid*

²⁵⁰ Coffey, A., & Atkinson, P., *Making sense of qualitative data: complementary research strategies*, (London: Sage Publications, 1996).

²⁵¹ *Ibid*

articles	quantitative analysis
Subjective in nature	Data is useful in testing of hypothesis
Consumes more time	Research is objective
Research is subjective	

This research project has essentially been carried out with the help of a qualitative approach, as elaborated in detail later in this section. It is evident from the review of literature that Islamic banking has been influenced by numerous religious, social and institutional variables. It is of particular relevance to note that Islamic banking practices have evolved in different ways in different countries, which in turn has resulted in significant lack in standardisation. It is thus clearly difficult and impractical to make use of quantitative research methods with their focus on objectivity, their rejection of subjective issues and thinking and their focus on numbers and statistics, rather than narratives and interpretation for this study. These factors have influenced the formulation of a qualitative research approach for this dissertation, which has been explained in greater detail subsequently in this chapter.

The adoption of the case study method of qualitative research analysis has helped in the identification of four appropriate countries, namely the UK, Saudi Arabia, Sharjah and Dubai for the purposes of this dissertation. The application of case study research has helped in bringing about standardisation in the nature of investigation and analysis and focus on obtaining information on areas like legislation, governmental policies, Sharia implications and the way forward for bringing about standardisation. The adoption of a qualitative approach has clearly helped significantly in the accessing of relevant information and their in-depth analysis.

2.5.4 Primary and Secondary Sources of Information

The conduct of social research frequently calls for the obtaining, accumulation, study and analysis of large amounts of information.²⁵³ Such information is obtained from sources that can be differentiated into two segments, namely primary and secondary information sources.²⁵⁴ Primary information is collected by the researcher, either through the study of official and proprietary documents, or through the conduct of questionnaire surveys, interviews and group

²⁵³ Yin, R.K., *Qualitative Research from Start to Finish*, (NY: Guilford Press, 2010).

²⁵⁴ *Ibid*

discussions with carefully chosen respondents.²⁵⁵ Secondary information sources however consist of the data that is prepared by experts who are unconnected with the research study and is available in the form of books, magazine articles, journal publications, research studies and even newspaper reports.²⁵⁶ Whilst primary information is very clearly extremely relevant to the subject under investigation, it is often time consuming, expensive and difficult to obtain, especially when it involves the conduct of surveys and interviews with respondents who are not known to the researcher.²⁵⁷ Secondary information is far easier to obtain but has to be carefully checked for genuineness and reliability of information as well as its relevance for a particular study.²⁵⁸ Social researchers make use of primary, secondary or both information sources in line with the demands of the study as well as the resources available with them.²⁵⁹

2.5.5 Formulation of Research Strategy

The formulation of an appropriate research method calls for the determination of overall research strategy.²⁶⁰ The survey of literature on various aspects of the research subject revealed that Islamic finance, a comparatively recent development in the area of international business, trade and finance was influenced by a multitude of variables.²⁶¹ It essentially comprised the method and mechanism of financing business as well as individual needs in adherence with the tenets of the Islamic religion. Islamic banking and finance had furthermore evolved in different ways in different countries like Saudi Arabia, UK, Sharjah and Dubai all the time being influenced by various interpretations of the Quran and other religious documents.²⁶² Such developments had overtime resulted in absence of standardisation for the application of different types of Islamic financial products. This research study deals with mortgages in the Royal Kingdom of Saudi Arabia, with particular regard to the enhancement of the legal system and financial processes of these mortgages. The study of available information also reveals that

²⁵⁵ *Ibid*

²⁵⁶ Babbie, E., *The practice of social research*, 9th edition, (NY: Belmont: Wadsworth, 2001).

²⁵⁷ *Ibid*

²⁵⁸ *Ibid*

²⁵⁹ *Ibid*

²⁶⁰ Bryman, A., & Bell, E., *Business research methods*, 2nd edition, (Oxford: Oxford University Press, 2007).

²⁶¹ Agha, O., "Islamic finance dispute resolution", *Leading Lawyers*: (2009) pp. 2.

²⁶² Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, 39, (2010): pp. 36-45.

standardisation was affected primarily because of the different interpretations of Islamic law with regard to different aspects of Islamic finance by Islamic experts in different geographies.²⁶³ Such differences in attitudes and approaches furthermore made it extremely difficult for banks to develop design and introduce Sharia compliant financial products.²⁶⁴ The researcher feels that the first step in the adoption of a research method would involve the formulation of the research study and determine whether it should be quantitative, qualitative and mixed method nature of approach.²⁶⁵ The researcher feels that the adoption of a quantitative method would not address the needs of this project on account of its rather linear and simplistic approach, especially in the face of numerous and different interpretations of the financial and other tenets of the Islamic religion by Islamic scholars.

The researcher has thus chosen to make use of a qualitative research approach for this dissertation. The adoption of a qualitative research study will provide the researcher with various investigating options, methods and models like content analysis, thematic analysis and case study analysis for the conduct of this exercise.²⁶⁶ It shall also enable him to make use of subjective narratives, wherever they are relevant for bringing out important information and details.²⁶⁷ This research projects has as such being carried out with the help of a qualitative research approach.

2.6 Research Method

With the researcher having decided to adopt a qualitative research strategy, it becomes important to discuss the available options for the conduct of qualitative investigation and analysis. Three of the more important tools and techniques used in qualitative study are (1) thematic analysis (2) and case study analysis (3) content analysis. These are taken up for detailed discussion below.

²⁶³ Aldohni, A.K., *The legal and regulatory aspects of Islamic banking*, (London: Routledge Publishers, 2012).

²⁶⁴ Allen, F., Brealey, R., & Myers, S., *Principles of Corporate Finance*, 8th edition, (New York: McGraw-Hill, 2005).

²⁶⁵ *Ibid*

²⁶⁶ Bryman, A., *Social research methods*, (Oxford: Oxford University Press, 2008).

²⁶⁷ *Ibid*

2.6.1 **Thematic Analysis**

Thematic analysis is one of the more common of analysis in qualitative research and focuses upon the pinpointing, examining and recording themes within the data.²⁶⁸ Themes constitute patterns across data sets that are relevant to specific research questions and become the focal point for analysis. It is important to appreciate that qualitative data collection is by and large dependent on interpretation.²⁶⁹ The data requires several types of explanation because social research generally results in the collection of a substantial amount of qualitative data.²⁷⁰ Denscombe informed that data should be made succinct through the use of suitable tables and charts, which can assist researchers in identification, comparison and determination of data that needs attention.²⁷¹ He added that it was necessary to clarify the connection between research objectives and the summary.²⁷² Ryan and Bernard informed that thematic analysis could be used for the qualitative examination of themes and classifications that were associated with data. Such analysis is considered to be suitable for studies that need interpretation and help in systematic analysis of data and the association of one theme with the total content.²⁷³ It provided a systematic element to data analysis and allowed researchers to associate a specific analysis of the frequency of a theme with one of the whole content.²⁷⁴ It provided an opportunity to understand the potential of an issue in greater depth.²⁷⁵

“Thematic Moves beyond counting explicit words or phrases and focuses on identifying and describing both implicit and explicit ideas. Codes developed for ideas or themes are then applied or linked to raw data as summary markers for later analysis, which may include comparing the relative frequencies of themes or topics within a data set, looking for code co-occurrence, or graphically displaying code relationships”²⁷⁶

²⁶⁸ Blacker, R., *A thematic analysis of psychodynamically-oriented supervision of observations in an acute inpatient ward*, (University of Leicester, 2009).

²⁶⁹ *Ibid*

²⁷⁰ *Ibid*

²⁷¹ Denscombe, M., *The Good Research Guide: For Small-scale Social Research Projects*, (NY: McGraw-Hill, 2010).

²⁷² *Ibid*

²⁷³ Ryan, G.W., & Bernard, H.R., “Techniques to identify themes”, *Field methods*, 15, 1, (2003): 85–109.

²⁷⁴ *Ibid*

²⁷⁵ *Ibid*

²⁷⁶ Denscombe, M., *The Good Research Guide: For Small-scale Social Research Projects*, p 138, (NY: McGraw-Hill, 2010).

Thematic analysis enables researchers to examine and assess the relationships between concepts and compare them with replicated data; this provides the potential to relate diverse concepts and opinions and compare them with data that has been obtained at different times in different situations.²⁷⁷ Boyatzis stated that thematic analysis was most appropriate in interpretation of data in both inductive and deductive approaches.²⁷⁸ It furthermore provided the opportunity for coding and categorising data into themes; process data could be displayed and classified according to its similarities and differences.²⁷⁹

Cohen stated that thematic analysis could be approached in different ways, namely inductive, deductive, semantic, latent, essentialist and constructionist.²⁸⁰ A researcher in thematic analysis firstly obtains familiarity with the data by reading and rereading it and becoming totally familiar with its content.²⁸¹ Familiarisation was followed by coding, which involved the generation of succinct labels that identified important data features expected to be relevant to answer the research question.²⁸² It also involved coding the complete data set and subsequently collating all data for later stages of analysis.²⁸³ Coding is by and large followed by searching for themes.²⁸⁴ This involves the examination of the codes and the collated data to identify broader patterns of meaning.²⁸⁵ It subsequently involves the collating of data so that the specific person can work with the data and review the viability of each candidate.²⁸⁶

The searching for themes is followed by the reviewing of themes; this phase involves the checking of the themes of candidates against the data set to determine that they tell a convincing story of the data and one that answers the research question.²⁸⁷ Themes are often refined in this section, which sometimes results in there being discarded, combined or split.²⁸⁸ Thematic review is followed by the defining and naming of themes, which in turn involves the developing of a detailed analysis of each theme, working out the focus and scope of each theme, assessing and

²⁷⁷ Boyatzis, R.E., *Transforming qualitative information: thematic analysis and code development*, London: Sage Publications, 1998).

²⁷⁸ *Ibid*

²⁷⁹ *Ibid*

²⁸⁰ Cohen, M.L., & Morrison, K., *Research Methods in Education*, 7th edition, (London: Routledge, 2011).

²⁸¹ *Ibid*

²⁸² *Ibid*

²⁸³ *Ibid*

²⁸⁴ Blacker, R., *A thematic analysis of psychodynamically-oriented supervision of observations in an acute inpatient ward*, (University of Leicester, 2009).

²⁸⁵ *Ibid*

²⁸⁶ *Ibid*

²⁸⁷ Boyatzis, R.E., *Transforming qualitative information: thematic analysis and code development*, (London: Sage Publications, 1998).

²⁸⁸ *Ibid*

evaluating the story of each and deciding on an informative term for each theme.²⁸⁹ The final phase involved the combination of the analytic narrative and the data extracts and contextualising the analysis with regard to existing literature.²⁹⁰

This research project has been carried out with the help of qualitative tools and techniques and the particular use of the case study method of research for accessing of information and the conduct of in-depth analysis on specific chosen geographies in some specific countries, i.e. the UK, Saudi Arabia, Sharjah and Dubai. It is of interest to note that whilst the case study method has been used for extraction and assimilation of data, the actual analysis has been carried out on the basis of specific themes, namely the impact of prohibition of Riba and Gharar on Islamic financing, the implications of sharing of profits and losses on banking activity, the role of Sharia in the spread of Islamic finance, the absence of standardisation in Islamic finance legislation in the UK, Sharjah, Dubai and Saudi Arabia. The use of thematic analysis has helped in the identification and crystallisation of these themes, which have been approached in an inductive and open-ended manner for the purpose of this study. The detailed analysis of these themes has helped significantly in approaching the analytical element of the study in a logical and constructive manner. It has also helped in the comparison and contrasting of various elements of Islamic banking and Islamic mortgage activity in the four chosen countries, namely the UK, Saudi Arabia, Sharjah and Dubai.

2.7 Research Process

As indicated in the earlier section, the research for this particular thesis shall be carried out with the help of an interpretivist / qualitative approach. The adoption of such an approach is considered to be suitable for research issues that are complex, multidimensional and multi-layered, as also those which are not considered to be amenable to the linear positivist approach and simplistic quantitative analysis.²⁹¹ The researcher has already elaborated upon three important and frequently used tools for qualitative analysis, i.e. thematic analysis, case study analysis and content analysis. The conduct of a case study, as indicated earlier results in the

²⁸⁹ *Ibid*

²⁹⁰ Denscombe, M., *The Good Research Guide: For Small-scale Social Research Projects*, p 138, (NY: McGraw-Hill, 2010).

²⁹¹ Saunders, M., Lewis, P., & Thornhill, A., *Research methods for business students*, 4th edition, (London: Prentice Hall, 2007).

generation of in-depth information on the chosen research subject and helps in the generation of valid, representative and generalisable outcomes.²⁹²

The researcher has accordingly chosen the case study method for the conduct of further research on this subject. It has firstly been decided to conduct case studies on Sharjah, Dubai and Saudi Arabia. All the states selected for this purpose are Islamic in nature, based in the Middle East and are integral members of the Gulf Coordination Council. Saudi Arabia is the acknowledged leader of the Arab world and has thriving banking and financial sectors as well as an extremely active stock exchange. Dubai and Sharjah are members of the UAE and are standalone city emirates with strong trading economies. It is also important to point out that Islamic banking has made significant inroads into all three of these countries, which in turn facilitates the conduct of research on specific areas of Islamic banking and finance.

2.7.1 Collection of Data

The collection of data for the purpose of this research project has involved the identification and location of appropriate secondary sources of information, followed by the detailed study and analysis. The writer has made use of several carefully chosen keywords in order to access suitable information sources. These information sources, after their identification and downloading have been examined carefully from the perspectives of correct / incorrect information, reliability of information sources, reliability of publication and relevance of the subject matter for the purpose of this research project.

The information for this project has been collected for two purposes, namely the preparation of a detailed literature review and the study of the four selected cases. The review of literature aims to develop focused information, which includes substantive findings, along with methodological and theoretical contributions to specific topics. Such reviews are developed from various secondary sources, including research studies, books, journal articles, and other media publications. It is meant to develop an up-to-date and comprehensive understanding of the subject through the review of carefully chosen information sources, followed by their comprehensive analysis in order to develop a multidimensional and impartial understanding of the subject.²⁹³ The literature review for this assignment was conducted in a systematic manner; in

²⁹² Hartley, J., Case study research. In Catherine Cassell & Gillian Symon (Eds.), *Essential guide to qualitative methods in organizational research*, (London: Sage, 2004).

²⁹³ Bryman, A., *Social research methods*. 2nd edition, (New York: Oxford University Press, 2004).

other words, secondary data was obtained by referring to a variety of sources, namely industry guidelines, law publications, academic journals, and books.²⁹⁴ As defined by Booth *et al.*, a systematic literature review consists of a critical evaluation and assessment of all of the research studies which pertain to a particular issue, with the use of an organised method in order to identify, assemble and to evaluate the studies with the use of a particular criteria.²⁹⁵

In order to ensure that as wide a range of studies was examined as possible; several academic databases were used in order to conduct the literature search. Specifically, the databases which were used consisted of Ovid Online, ICE Virtual Library, Wiley Online Library, Ingenta Connect, Hein Online, MUSE, Sage Journals Online, Cambridge Journals Online and JStor. This was supplemented by searches that were conducted on legal databases such as Lexis Nexis. In order to identify relevant studies, various combinations of the following search terms were utilised: ‘Murabaha’, ‘Sharia compliance’, ‘Islamic mortgages’, ‘Islamic finance’, ‘regulation of Islamic finance’, ‘limited Sharia compliance’, ‘Sharia boards’, ‘Islamic banks’ and ‘Islamic corporate finance’. In order to ensure that the studies that were identified were as relevant as possible, it was stipulated as part of the search that the studies should only be English language and that they should have been published within the last five years i.e. since 2009. The searches of the databases were also supplemented by regular searches of the Google books database in order to identify any books which had been recently published concerning the research topic.

The studies that were identified as a result of these searches demonstrated a number of specific themes. For example, while the majority of the studies that were identified highlighted issues such as the legislation relating to mortgages within the UK, and the way in which Islamic mortgages were addressed within this framework, some studies also highlighted issues such as the extent to which *Sharia* compliance in the UK may be limited by the restricted independence of *Sharia* boards.

The search strategy that was utilised was highly effective at locating research studies which were relevant to the chosen research topic; however, the fact that the search parameters had been set to only identify research dating from 2009 meant that the number of studies was restricted. The limited number of studies meant that the insight into the reasons for the limited

²⁹⁴ Booth, A., Papaioannou, D., & Sutton, A., *Systematic approaches to a successful literature review*, (Cambridge: Cambridge University Press, 2012).

²⁹⁵ *Ibid*

level of *Sharia* compliance within the UK was not investigated in depth by any of the studies. In order to rectify this perceived gap in the literature, the parameters of the search strategy were altered to include studies that had been published within the last ten years, thus increasing the number of studies which were included. The widening of the search parameters meant that more studies were included which examined the issue of *Sharia* compliance in *Murabaha* products in greater detail, with a particular focus on the way in which the failure to comply with the order of the different stages in *Murabaha* may violate *Sharia* principles. In the opinion of the author, the broadening of the search criteria meant that more detailed insights into the research topic could be achieved.

The researcher feels that the application of this research process has led to the development of a comprehensive and informative literature review.

2.8 Case Study Analysis

Case studies are used across the social sciences and are increasingly being used as rigorous research studies in their own right.²⁹⁶ Hamel suggested that case studies have swiftly become an important and often used method to carry out qualitative enquiry.²⁹⁷ Eisenhardt stated that the need for case studies specifically arises out of the requirement for understanding and appreciating complex social phenomena, especially because it enables investigators to retain and consider the meaningful and holistic characteristics of real life processes like organisational and managerial activity.²⁹⁸ Case studies can be focused on historical events, even as they can be exploratory and descriptive in nature.²⁹⁹ Gillham identified three types of case studies, namely intrinsic, collective and instrumental.³⁰⁰

It is important to keep in mind that concerns have repeatedly been expressed about the difficulty of using case studies for scientific generalisation.³⁰¹

A “weak” form of generalisation often associated with case studies is ‘naturalistic generalisation’. The term implies that case studies offer working hypotheses that may be

²⁹⁶ Hamel, J., *Case study methods*, (Thousand Oaks: Sage, 1993).

²⁹⁷ *Ibid*

²⁹⁸ Eisenhardt, K. M., “Building theories from case study research”, *Academy of Management Review*, 14, 4, (1989): 532-550.

²⁹⁹ *Ibid*

³⁰⁰ Gillham, B., *Case study research methods*, (London: Continuum, 2000).

³⁰¹ Kolberg, L., “*Case Studies and Generalization*”, (2003), <

<https://www.bi.no/upload/Hjemmesider/fgl00076/Paper%20DRE%201002.pdf>>

appropriate for other cases if the ‘fit’ between the cases is close enough. It is apparently up to anyone to judge whether the fit is close or not. Therefore, it introduces an element of everyday common-sense reasoning. This might work. After all we often rely on this kind of generalisation, but our everyday generalisations are also shown to be erroneous and indeed biased. Using naturalistic generalisation as the form of generality possible to achieve from case studies therefore implies sort of a capitulation: real general conclusions may not be sought and case studies are still an inferior science to statistical research.³⁰²

Advocates of case studies however state that case studies are generalisable for theoretical propositions rather than to populations of universes; the case study does not represent a sample and is more useful for the generalisation of theories.³⁰³

The case study analysis essentially constituted the empirical investigation of a contemporary development within its actual ambit, especially when the demarcation between the development and its context was not clear.³⁰⁴ It was useful in the examination of technically unique circumstances characterised by variables of interest.³⁰⁵ With one outcome dependent upon many empirical evidence sources, the need for the triangulation of information and the benefits of a result from the earlier formulation of theoretical propositions for influencing of obtaining and analysing the data.³⁰⁶ It was a methodological option that facilitated the utilisation of quantitative and qualitative approaches.³⁰⁷

The use of case study helps in investing and assessing a diverse array of information and the maximisation of benefits from multiple evidence sources.³⁰⁸ Gomm *et al* stated that the benefits from these 6 sources of evidence could be maximised if researchers made use of multiple sources of evidence, created a case study database and maintained a chain of evidence.³⁰⁹ Gilliam stated that the use of several evidence sources was a distinguishing feature of case study analysis; researchers made use of all evidence and did not reject anything.³¹⁰

³⁰² *Ibid*, p 3

³⁰³ *Ibid*

³⁰⁴ Hartley, J., Case studies in organizational research. In Catherine Cassell & Gillian Symon (Eds.), *Qualitative methods in organizational research, a practical guide*, (London: Sage, 1994).

³⁰⁵ *Ibid*

³⁰⁶ Eisenhardt, K. M., “Building theories from case study research”, *Academy of Management Review*, 14, 4, (1989): 532-550

³⁰⁷ *Ibid*

³⁰⁸ *Ibid*

³⁰⁹ Gomm, R., Hammersley, M., & Foster, P., *Case study method, key issues, key texts*, (London: Sage, 2000).

³¹⁰ Gillham, B., *Case study research methods*, (London: Continuum, 2000).

Saunders *et al* stated that data collection in case studies, goes hand in hand with analysis and is developed together in an iterative process that can actually be strength as it facilitates theory development that is grounded in empirical evidence.³¹¹The detailed and careful description of evidence and the generation of classes for allocation of behaviours have over time proved to be extremely useful in data analysis.³¹²Bryman and Bell informed that data analysis in case studies comprised the examination, categorisation, testing, tabulation or otherwise recombining qualitative and quantitative evidence to address the initial propositions of a project.³¹³ Data analysis in this case is often concerned with a search for patterns in data.³¹⁴The identification of a pattern was taken up for interpretation in terms of the setting or the social theory in which it occurs.³¹⁵

2.9 What Data Was Collected?

The data collected for this purpose pertained to the formulation and commercial implementation of Islamic finance mortgages and securitisation in three chosen geographies, namely the UK, Sharjah, Dubai and Saudi Arabia. The data for this purpose was collected from an extensive range of secondary information sources, available in the public domain in the form of research studies, journal articles, organisational websites and other media publications. The information obtained has been discussed in detail in chapter 5 and thereafter analysed with the help of appropriate themes in chapter 6 to arrive at in-depth conclusions and findings.

2.10 Examination and Analysis of Data

The collected data from online search was carefully transcribed by the researcher and thereafter subjected to qualitative analysis. The researcher examined the data with particular

³¹¹Saunders, M., Lewis, P., & Thornhill, A., Research methods for business students, 4th edition, (London: Prentice Hall, 2007).

³¹²*Ibid*

³¹³Bryman, A., & Bell, E., Business research methods, 2nd edition, (Oxford: Oxford University Press, 2007).

³¹⁴*Ibid*

³¹⁵*Ibid*

regard to the existing mortgage model, securitisation and the legal systems of the three chosen states, i.e. UK, Sharjah, Dubai and Saudi Arabia. The information obtained from secondary sources has been subjected as mentioned earlier to extensive discussion and analysis in chapter 5 and chapter 6.

2.11 Conclusions

This section provided comprehensive details on the research method chosen by the researcher for the conduct of this dissertation.

The research for this project has been carried out with the adoption of an interdisciplinary approach. The application of an interdisciplinary approach entails the use of relevant information from two or more disciplines in the collection, examination and analysis of information for the purposes of research. Such an interdisciplinary approach helps researchers in avoiding the creation of silos, the generation of a more comprehensive understanding of the research subject, the generation of a wider audience of readers from other disciplines and in the development of new and fresh ideas.³¹⁶ Whilst the use of the interdisciplinary approach does result in greater time requirements, modern researchers feel that the enhancement of the quality of research outcomes makes this worthwhile.³¹⁷ This research project has been carried out with secondary information from several disciplines, especially finance, banking, management, law and religion. The adoption of multidisciplinary approach has helped in the conduct of multidimensional research and the generation of in-depth, deeply researched and cross-linked outcomes.

The researcher has carried out a comparative study of the merits and demerits of the positivist, interpretivist and mixed method models of research and has chosen the interpretivist and qualitative approach because it was considered to be most suitable for the investigation of research subjects that were complex, multidimensional and multi-layered in nature. The researcher has furthermore examined the ways and means for carrying out thematic, content and case study analysis for the purposes of this study and has again come to the conclusion that the adoption of a case study method will enable him to drill down into the subject matter and generate truly in-depth outcomes. This research study has been carried out with the help of a qualitative approach, which is essentially based upon inductive logic and makes use of

³¹⁶ *Ausburg, T., Becoming Interdisciplinary: An Introduction to Interdisciplinary Studies*, 2nd edition (New York: Kendall/Hunt Publishing, 2006).

³¹⁷ *Ibid*

exploratory investigation on the Islamic mortgaging practices in four geographies, i.e. the UK, Saudi Arabia, Dubai and Sharjah. The information obtained has been subjected to comparison, contrast and thematic analysis to arrive at well researched and valid findings on the diverse research questions.

The case study method of analysis is becoming increasingly popular in the conduct of social research, despite doubts being expressed about its representativeness and the generalisability of its findings.³¹⁸ The case study method provides researchers with the facility of making use of both quantitative and qualitative approaches in their quest for information on the research issue.³¹⁹

“Case studies are popular for a number of reasons, one being that they can be conducted at various points in the research process. Researchers are known to favour them as a way to develop ideas for more extensive research in the future – pilot studies often take the form of case studies. They are also effective conduits for a broad range of research methods; in that sense, they are non-prejudicial against any particular type of research – focus groups are just as welcome in case study research as are questionnaires or participant observation.”³²⁰

The researcher has accordingly chosen four cases, namely those of UK, Sharjah, Saudi Arabia and Dubai for the conduct of this research study. The choice of four case studies for the conduct of this investigation has ensured appropriate representativeness and generalisability to the outcomes. It is relevant to point out that the case study method of research has been used by other researchers, for example Kettell (2011)³²¹, Misman and Bhatti (2009)³²² and Qasam (2004)³²³ for examination of various aspects of Islamic finance with useful results and outcomes. Qasam (2004) research efforts resulted in the awarding of a PhD by Lough Borough

³¹⁸ Hartley, J., Case study research. In Catherine Cassell & Gillian Symon (Eds.), *Essential guide to qualitative methods in organizational research*, (London: Sage, 2004).

³¹⁹ *Ibid*

³²⁰ Curtis, W., *Research and Education* (Foundations of Education Studies), (London: Routledge, 2013, p 81)

³²¹ Kettell, B., “*Case Studies in Islamic Banking and Finance*”, (2011), <<https://nurulichsanaan.files.wordpress.com/2015/10/introduction-to-islamic-banking-and-finance-case-studies-case-questions-answers-brian-kettell-2011.pdf>>

³²² Misman, F.N., & Bhatti, M.I., “*Risks Exposure in Islamic Banks: a Case Study of Bank Islam Malaysia Berhad (BIMB)*”, (2009), <<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan049142.pdf>>

³²³ Qasam, A.A., “*Islamic banking regulation and supervision: a case study of Jordan*”, (2004), <<https://dspace.lboro.ac.uk/dspace-jspui/handle/2134/7613>>

University.³²⁴The use of the case study method for this research has, apart from the achievement of representativeness, generalisability and validity, made it possible to compare and contrast the Islamic mortgaging laws, rules, regulations and practices in four important geographies and compare and contrast them in accordance with specific themes in order to arrive at valid conclusions and outcomes.

The next section provides details about ancient laws of mortgages and modern law of securitisation. This section will essentially provide a legal and conceptual framework on mortgages and securitisation and enable the conduct of an objective and compare / contrast the study of the mortgage of securitisation issues of three chosen geographies.

Chapter 3: Literature Review

3.1 Introduction

This review of literature, as elaborated earlier has been developed with the help of various carefully selected and scrutinised information sources, primarily from the online space. The review aims to provide a detailed and analytical understanding of the research subject. It has been divided into three parts, namely (1) a critical review of secular finance theory, (2) a critical analysis of Islamic finance products and (3) an analysis of the comparative performance of conventional and Islamic banks during the financial crisis. The dissertation focuses on the examination of Islamic finance products and the ways and means that can be adopted to make these products acceptable and attractive to a large consumer base by ensuring higher degrees of Sharia compliance, standardisation and harmonisation. The first section accordingly focuses on various elements of secular or non-religious finance theory, as followed and adhered to by the western banking and financial system. The second section on the other hand focuses on diverse elements of Islamic finance and Islamic finance products. The placement of such information in two specific sections following one after the other helps in comparing and contrasting them without much difficulty.

The literature review contains a detailed analysis of the existing legislative framework concerning the provision of home financing packages within UK law, and the way in which the

³²⁴*Ibid*

provision of Islamic mortgages has been dealt with within this legislative framework. It then goes on to critically analyse the findings of various studies which discuss the extent to which *Sharia* compliance may be restricted by the UK's legislative system. The literature review then goes on to critically analyse the extent to which Islamic mortgages provided within the UK are actually compliant with *Sharia* principles. Various studies examine potential reasons for limited *Sharia* compliance within the UK are reviewed, with a focus on the extent to which factors such as the lack of independence of *Sharia* boards, and the failure of some Western financial institutions to conduct the stages of the *Murabaha* agreement in the required order. We subsequently compare the extent of *Sharia* compliance within mortgage products in the UK which could be learnt by the UK government in order to ensure that the mortgage products which that are provided to its Muslim consumers are more closely compliant to *Sharia* principles, while also reflecting on whether there are any intrinsic barriers which exist to *Sharia* compliance within Western, non-Muslim countries. The chapter concludes with a discussion of the existing gaps within the research literature, and the extent to which this gap within the research will be addressed within the thesis. Part II provides a similar and detailed analysis of Islamic banking tenets, including an overview of Islamic financial products and standardisation of *Sharia* principles.

3.2 Critical Review of Secular Finance Theory

3.2.1 Critical Reflection of the Financial Crisis of 2008 and its Consequences

The occurrence of the banking, financial and economic crisis of 2008-2010 can be categorically termed as the most important financial and economic occurrence of the 21st century. It was compared in its dimensions to the great depression of the 1930s and radically altered the global economy and global society. With the banking crisis, which triggered off the larger financial and economic crisis, essentially stemming from the mortgage banking sector of the United States, a detailed discussion of its causes and its consequences is essential for the purposes of this dissertation.

3.2.2 Minsky's Theory of Financial Crisis

Minsky, in his description of the reasons of a financial crisis stated that the movement of business monies during periods of economic affluence went much beyond the amount needed for meeting of debt and led to the development of unfounded enthusiasm and joy.³²⁵ Such joy led to people assuming loans that could not be appropriately serviced by their existing incomes.³²⁶ The taking place of enormous growth in borrowings, followed by inadequate meeting of debt obligations on account of insufficient accessibility of funds led to the generation of financial difficulties.³²⁷

Wolfson argued that financial institutions and bankers tended to lower the provisioning of credit in reaction to non-payment of debt, which was consequently liable to result in lowering and tightening of production, trade and other economic activity.³²⁸ Such a voyage from steadiness and stability to intense volatility involved three particular stages of borrowing, namely (1) hedge, (2) speculative and (3) Ponzi.³²⁹ The hedging stage generally involved the utilisation of debt that liquidated itself and was thus felt to be secure. The speculative stage conversely involved borrowings with higher risk, characterised by incoming cash flows that may cover interest but not the main or amount.³³⁰ Ponzi, the last stage involved borrowings, wherein speculators could not satisfy either their funding or their principal borrowings and relied on inflation in the prices of assets to survive.³³¹

³²⁵ Kara, A., Marques-Ibanez, D., & Ongena, S., “*Securitization and lending standards: Evidence from the wholesale loan market*”, (2010),

<https://www.ecb.europa.eu/events/conferences/shared/pdf/Securitisation_and_lending_standards.pdf?ad13e1f1d6809d13f369a6c84e9f4d48http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf<https://www.ucm.es/data/cont/media/www/pag-41460/Minsky%20theory%20of%20financial%20crisis.pdf><http://www.economicshelp.org/blog/6864/economics/financial-instability-hypothesis/>>

³²⁶ Baker, C., “The Federal Reserve as last resort”, *University of Michigan Journal of Law Reform*, 46, 1, (2012): 69-133.

³²⁷ Erel, I., Nadauld, T., & Stultz, R.M., “Why did holdings of highly rated securitization tranches differ so much across banks?”, *The Review of Financial Studies*, 27, 2, (2014): 404-453.

³²⁸ Wolfson, H. M., “Minsky's Theory of Financial Crisis in a Global Context”, *Journal of Economic Issues*, 36, 2, (2002): 393-399.

³²⁹ *Ibid*

³³⁰ Anabtawi, I., & Schwarcz, S. L., “Regulating ex post: How law can address the inevitability of financial failure?”, *Texas Law Review*, 92, (2013): 75-131.

³³¹ *Ibid*

3.2.3 The Build Up to the Global Financial Crisis

The circumstances that resulted in the development of the financial crisis took place over a long time period.³³² The two preceding decades, i.e. from the late 1990s to the first half of the 2000 were marked by progressive enhancement in economic enlargement and development in the United States.³³³ Such expansion was primarily motivated by the implementation and sustenance of a low interest environment in the USA, which again was driven by the incessant inward movements of cash flows from other countries particularly China .³³⁴

The Chinese economy expanded enormously during the 1990s, resulting in continuously growing revenues and cash flows, which were ultimately parked in American banks because of the US domination of global finance, trade and business.³³⁵ Such cash inflows with American banks led to the formulation and establishment of a low interest environment.³³⁶ The US banking sector, assisted by the Federal Reserve, aimed to improve their revenues and profits by lending the large sums of monies with them at low interest rates.³³⁷

The substantial finances available with US banks resulted in the development of an immense boom in the US housing sector.³³⁸ Numerous banks across the country engaged in competition with each other to provide funds to their customers for buying residential properties.³³⁹ Banks provided funds after applying a range of risk management procedures; these include the scrutiny and examination of potential borrowers, the examination of the repayment capacity and the valuation of the residential property chosen for mortgaging.³⁴⁰ American bankers

³³² Lang, W. W., & Jagtiani, J. A., "The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance", *Atlantic Economic Journal*, 38, (2010): 295-316.

³³³ Crotty, J., "Structural causes of the global financial crisis: a critical assessment of the 'new financial architecture'", *Cambridge Journal of Economic*, 33, (2009): 563-580.

³³⁴ Lang, W. W., & Jagtiani, J. A., "The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance", *Atlantic Economic Journal*, 38, (2010): 295-316.

³³⁵ Ashby, S., "The 2007-09 Financial Crisis: Learning the Risk Management Lessons", (Mimeo: Nottingham Business School, 2010).

³³⁶ Chernenko, S., & Sunderam, A., "Frictions in shadow banking: evidence from the lending behavior of money market mutual funds", *The Review of Financial Studies*, 27, 6, (2014): 1717-1750.

³³⁷ *Ibid*

³³⁸ Calluzzo, P., & Dong, G.N., "Has the financial system become safer after the crisis? The changing nature of financial institution risk", *Journal of Banking and Finance*, 53, (2015): 233-248.

³³⁹ *Ibid*

³⁴⁰ Foo, C., "Conceptual lessons on financial strategy following the US sub-prime crisis", *The Journal of Risk Finance*, 9, 1, (2008): 292-302.

however came to the conclusion that the regular application of such risk management mechanisms would slow down their lending business.³⁴¹

These bank managers developed a false confidence in providing loans to lower income segments, termed subprime borrowers on account of specific reasons.³⁴² American bank managers assumed that inadequate ability in loan repayment did not comprise an important risk because the homes of defaulters could be taken back and resold with significant mark-ups in an inflationary environment.³⁴³ US bankers were helped in such risky lending by the availability of a few new developed financial tools, namely (a) Mortgage Backed Securities (MBS), (b) Securitisation, (c) Credit Derivatives (CDs) and (d) Special Purpose Vehicles (SPVs).³⁴⁴ These tools helped them in bundling several loans, reselling them and transferring them from the financial statements.³⁴⁵ Numerous bankers across the US thus loosened their credit standards for customer examination and selection in order to enlarge their mortgage activity.³⁴⁶ American bank managers, motivated by the lure of higher organisational profitability and greater performance bonuses, intentionally provided loans to people with insufficient incomes and loan repayment capacities.³⁴⁷

3.2.4 The Subprime Crisis in the USA

As explained earlier, American bankers intentionally chose to offer housing mortgages to individuals from low income segments.³⁴⁸ Enormous funds were provided to subprime and Alt-A borrowers, i.e. who were at one level above subprime borrowers in the credit ranking norms used by American bankers.³⁴⁹ Loan disbursements to the subprime segment increased from approximately

³⁴¹ Rotheli, T. F., "Causes of the financial crisis: Risk misperception, policy mistakes, and bank's bounded rationality", *The Journal of Socio-Economics*, (2010): 119-126.

³⁴² *Ibid*

³⁴³ Erel, I., Nadauld, T., & Stultz, R.M., "Why did holdings of highly rated securitization tranches differ so much across banks?", *The Review of Financial Studies*, 27, 2, (2014): 404-453.

³⁴⁴ Foo, C., "Conceptual lessons on financial strategy following the US sub-prime crisis", *The Journal of Risk Finance*, 9, 1, (2008): 292-302.

³⁴⁵ Rotheli, T. F., "Causes of the financial crisis: Risk misperception, policy mistakes, and bank's bounded rationality", *The Journal of Socio-Economics*, (2010): 119-126.

³⁴⁶ Foo, C., "Conceptual lessons on financial strategy following the US sub-prime crisis", *The Journal of Risk Finance*, 9, 1, (2008): 292-302.

³⁴⁷ Allen, L., Bali, T.G., & Tang, Y., "Does systemic risk in the financial sector predict future economic downturns?", *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

³⁴⁸ Barth, R. J., Li, T., Lu, W., & Yago, G., *The Rise and Fall of the U.S. Mortgage and Credit Markets, A Comprehensive Analysis of the Meltdown*, (NY: John Wiley & Sons: 2009).

³⁴⁹ Beltratti, A., & Stulz, R.M., "The credit crisis around the globe: Why did some banks perform better?", *Journal of Financial Economics*, 105, 1, (2012): 1-17.

10% of the total mortgage amount to more than 19% between 2000 and 2006.³⁵⁰ The quantum of subprime lending increased from 34 billion USD in 1993 to approximately 161 billion USD in 2000 and subsequently to 625 billion USD in 2007.³⁵¹ Subprime mortgages increased by 175 billion USD in 2000 to more than 690 billion USD in 2006; the growth in this regard was in excess of 300%.³⁵²

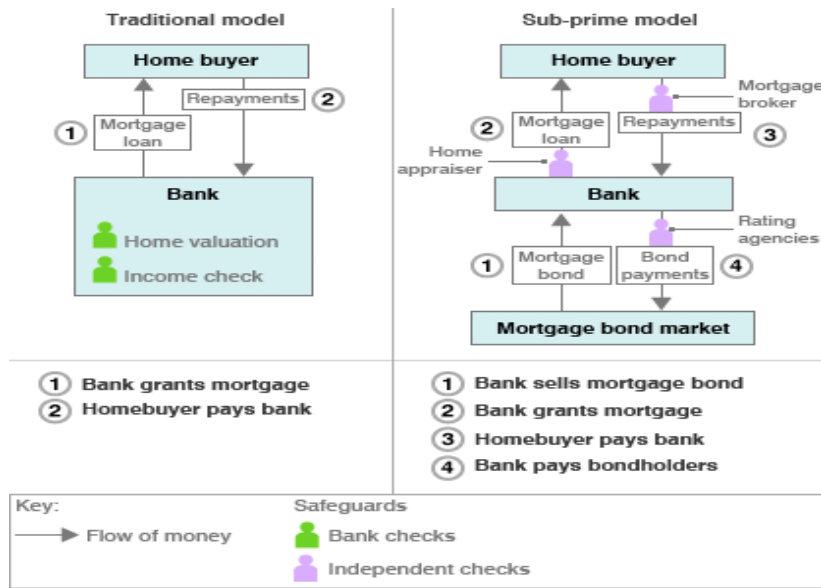
The following diagram provides details about the dissimilarities between the conventional and subprime processes for home mortgages.

³⁵⁰ BBC News, “*The downturn in facts and figures*”, (2007), <news.bbc.co.uk/2/hi/7073131.stm>

³⁵¹ Dickerson, A. M., “Over-Indebtedness, the Subprime Mortgage Crisis and the Effect on U.S. Cities”, *Fordham Urban Law Journal*, 36, 3, (2009): 395.

³⁵² BBC News, “*The downturn in facts and figures*”, (2007), <news.bbc.co.uk/2/hi/7073131.stm>

Chart 2: Differences between the Traditional and Subprime Models of Lending³⁵³



The enormous increase in home lending by US banks resulted in a tremendous boom in the US housing sector; the costs of both land and housing expanded to unimaginable levels and bank customers engaged in exorbitant borrowings to fund their homes.³⁵⁴ Many people with one homes bought another, even as numerous individuals bought costly homes without assessing their repayment abilities.³⁵⁵ Home borrowings grew enormously across the US economy.³⁵⁶ Individual banks enhanced their debt equity leveraging substantially; credit card borrowings expanded swiftly; the mortgage business grew dramatically and intense inflation occurred in the housing sector.³⁵⁷ The entire US economy became overheated because of the growing bubble in the housing sector.³⁵⁸

The subprime crisis occurred when numerous home borrowers started failing in their payment obligations, leading their bankers and mortgagers to take repossession of their homes

³⁵³ *Ibid*

³⁵⁴ Chernoff, A., "Lehman Brothers a victim of US subprime crisis", *IBN Live*, (2008), <ibnlive.in.com> Business>

³⁵⁵ Caballero, R. J., Farhi, E., & Gourinchas, P., "Financial Crash, Commodity Prices and Global Imbalance", *Brookings Papers on Economic Activity*, 2, (2008): 1-55.

³⁵⁶ *Ibid*

³⁵⁷ Berger, A.N., & Bouwman, C.H.S., "How does capital affect bank performance during financial crises?", *Journal of Financial Economics*, 109, (2013): 146-176.

³⁵⁸ *Ibid*

and publicly auction them to recover their debts.³⁵⁹ The placement of numerous such repossessed homes in the auction market resulted in swift lowering in home prices, numerous mortgage defaults and the swift collapse of the US housing sector.³⁶⁰ Subprime loans, it needs to be mentioned, were packaged by various banks and intermediaries into seemingly attractive investment opportunities and marketed to diverse banks and hedge funds.³⁶¹ These investors came to realise that their investments did not have either value or buyers.³⁶² The subprime problem thus established the stage for the creation of a worldwide banking, financial and economic crisis.³⁶³

3.2.5 The Role of Banks and Financial Institutions in the Credit Crisis

American banks drove the onset and spread of the worldwide financial crisis in diverse ways.³⁶⁴ They were firstly responsible for creating the housing boom by offering high levels of credit to thousands of borrowers who undoubtedly did not possess the means for repayment of the interest or the principal amount of their borrowings.³⁶⁵ They secondly intensified the dissemination of systemic risk through the American, European and worldwide financial and banking framework with their usage of recently created financial tools like (1) securitisation, (2) derivatives, (c) mortgage backed securities and (4) special purpose vehicles.³⁶⁶ These tools were utilised to bundle high risk housing loans, segment them into saleable securities and consequently sell them to several investors with dissimilar risk profiles.³⁶⁷ The use of such strategies and tools facilitated banks and financial institutions in transferring risky loans from the financial statements and thereafter making use of their window dressed balance sheets to engage in further borrowing in order to earn high and unsustainable profits.³⁶⁸

³⁵⁹ Ely, B., "Bad Rules Produce Bad Outcomes: Underlying Public-Policy Causes of the U.S. Financial Crisis", *The Cato Journal*, 29, 1, (2009): 93.

³⁶⁰ Caballero, R. J., Farhi, E., & Gourinchas, P., "Financial Crash, Commodity Prices and Global Imbalance", *Brookings Papers on Economic Activity*, 2, (2008): 1-55.

³⁶¹ Pearsonhighered, *The Global Financial Crisis*, (2012),

<http://www.pearsonhighered.com/assets/hip/us/hip_us_pearsonhighered/samplechapter/0205231527.pdf>

³⁶² *Ibid*

³⁶³ Anabtawi, I., & Schwarcz, S.L., "Regulating Systemic Risk: Towards an Analytical Framework", 86 *Notre Dame Legal Review*, 86, 4, (2011): 1349-1412.

³⁶⁴ Adam, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

³⁶⁵ Anderson, G.R., & Mullineux, A.W., "*British Banking in Crisis*", (2009),

<<http://research.stlouisfed.org/publications/es/09/ES0916.pdf>>

³⁶⁶ *Ibid*

³⁶⁷ *Ibid*

³⁶⁸ Caballero, R. J., Farhi, E., & Gourinchas, P., "Financial Crash, Commodity Prices and Global Imbalance", *Brookings Papers on Economic Activity*, 2, (2008): 1-55.

The use of these various strategies and instruments and tools also resulted in the dissemination of substantial systemic risk across the interrelated western and financial and banking framework; this resulted in an environment where the failure of one bank could impact the financial stability of all banks.³⁶⁹

The examination of the fate of Lehman Brothers demonstrates the risks that were taken on by members of the banking sector and the causes behind their collapse after the bursting of the housing.³⁷⁰

3.2.6 The downfall of Lehman Brothers

Lehman Brothers, a globally well-known American financial institution entered into subprime lending in 2003 through the acquisition of five firms engaged in mortgage lending activities.³⁷¹ It thereafter assumed substantially high risks by participating in underwriting mortgage backed securities.³⁷² Lehman Brothers, in the process created a subprime business valued at about 85 billion USD, which amounted to 400% of its shareholder equity and led to significant growth in its financial leverage.³⁷³

There is little doubt that investment banks have in the past frequently financed their lending operations with the help of borrowings.³⁷⁴ Enhancement of leverage thus obviously assists in enhancement of business volumes and organisational profitability.³⁷⁵ Such expansion in leverage nevertheless also results in augmentation of financial risks because of the need to service the borrowings.³⁷⁶ The management of Lehman Brothers intentionally chose to adopt a forceful and risky lending strategy, assuming that its loans would be safeguarded by the

³⁶⁹ Ayadi, R., Schmidt, R.H., & Valverde, S.C., “Investigating diversity in the Banking Sector in Europe – The performance and role of savings banks”, (Center for European Policy Studies, Brussels, 2009).

³⁷⁰ Adam, A., & Schuermann, T., “Understanding the Securitization of Subprime Mortgage Credit”, *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

³⁷¹ Davis, E. P., & Karim, D., “Could early Warning Systems Have Helped to Predict the Sub-Prime Crisis”, *National Institute Economic Review*, 206, (2008): 35.

³⁷² *Ibid*

³⁷³ *Ibid*

³⁷⁴ Chernenko, S., & Sunderam, A., “Frictions in shadow banking: evidence from the lending behavior of money market mutual funds”, *The Review of Financial Studies*, 27, 6, (2014): 1717-1750.

³⁷⁵ Sheppard's, R., “The Fall-Out from Lehman Brothers”, Collapse Explained, *Daily Post, Liverpool, England*, (2008): 7.

³⁷⁶ Adam, A., & Schuermann, T., “Understanding the Securitization of Subprime Mortgage Credit”, *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

continuously growing home prices in the USA.³⁷⁷ The appraisal of Lehman’s financial statements for 2007 reveals the following³⁷⁸.

Table 3: Lehman’s Financial Statements for 2007³⁷⁹

Item	Details
Revenues at close	59,003 Million USD
Profits at close	4,192 Million USD
Assets at close	691,063 Million USD
Stockholder’s Equity at close	22,490 Million USD
Profits as a percentage of Revenues	7.1%
Profits as a percentage of Assets	0.6%
Profits as a percentage of Stockholder’s Equity	18.6%
Earnings per Share in 2007	7.26 USD
Percentage Change in Earnings per share from 2006 to 2007	6.6%
Annual Growth rate from 1997-2007	19.9%

Financial experts agree that enhancement in financing of company assets through external borrowings leads to enhanced leverage, substantially increased financial vulnerability and substantially higher chances of bankruptcy at the time of economic difficulties or sharp reduction in the value of assets.³⁸⁰ It must also be kept in mind that growth in firm leverage facilitates the occurrence of erosion in the firm’s equity in reaction to comparatively smaller reduction in the values of assets.³⁸¹ The management of Lehman brothers increased firm leverage to an extraordinary level of more than 30:1 by the end of 2006, aiming to augment organisational

³⁷⁷ Fox, J., “Three Lessons of the Lehman Brothers Collapse”, *www.time.com*, (2009), <www.time.com/time/business/article/0,8599,1923197,00.html>.

³⁷⁸ Chernoff, A., “Lehman Brothers a victim of US subprime crisis”, *IBN Live*, (2008), <ibnlive.in.com > Business>

³⁷⁹ Chernoff, A., “Lehman Brothers a victim of US subprime crisis”, *IBN Live*, (2008), <ibnlive.in.com > Business>

³⁸⁰ Davis, E. P., & Karim, D., “Could early Warning Systems Have Helped to Predict the Sub-Prime Crisis”, *National Institute Economic Review*, 206, (2008): 35.

³⁸¹ Barth, R. J., Li, T., Lu, W., & Yago, G., *The Rise and Fall of the U.S. Mortgage and Credit Markets, A Comprehensive Analysis of the Meltdown*, (NY: John Wiley & Sons: 2009).

profits through the provisioning of greater loans.³⁸²The organisational management assumed that constant growth in home prices would safeguard their assets and help in driving their firm's growth and profits to unprecedented heights.³⁸³

Lehman's total asset value grew to 786 billion USD by the end of the first quarter of 2008, more than 40% of what it was a year ago.³⁸⁴ Experts stated that approximately one third of the firm's assets were illiquid because of being invested in long term commitments.³⁸⁵Lehman's high risk borrowing strategy made it extremely vulnerable to financial developments.³⁸⁶The collapse in the housing sector led to swift reductions in home prices; Lehman's attempts to sell its various and largely illiquid assets did not succeed in an unsteady, volatile and apprehensive environment.³⁸⁷ The absence of liquidity in Lehman's assets was instrumental in its collapse³⁸⁸. Sharp drops in Lehman's asset values, consequent financial losses and failure in obtaining additional borrowing to fund its short-term obligations resulted in the management opting to file for bankruptcy.³⁸⁹

The problems and challenges faced by Lehman brothers were repeated across the United States in several other banks and financial institutions including Fannie Mae, Freddie Mac, Morgan Stanley and Citibank.³⁹⁰A few of these establishments were rescued by help from the government, whilst numerous others failed.³⁹¹ The huge financial problems that arose in the US banking sector led to fear, panic and worry across Europe, substantial losses, and high levels of apprehension and the generation of a substantial and long drawn out credit squeeze.³⁹² Such unpredicted and sharp reduction in availability of funds led to fund starvation in thousands of

³⁸² Beltratti, A., & Stulz, R.M., "The credit crisis around the globe: Why did some banks perform better?", *Journal of Financial Economics*, 105, 1, (2012): 1-17.

³⁸³ *Ibid*

³⁸⁴ Chernoff, A., "Lehman Brothers a victim of US subprime crisis", *IBN Live*, (2008), <ibnlive.in.com > Business>

³⁸⁵ *Ibid*

³⁸⁶ Wessel, D., "Government's Trial and Error Helped Stem Financial Panic", *The Wall Street Journal*, (2009), <online.wsj.com/article/SB125288495316307191.html>.

³⁸⁷ Allen, L., Bali, T.G. & Tang, Y., "Does systemic risk in the financial sector predict future economic downturns?", *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

³⁸⁸ Doren, P. V., "Lehman Brothers and Bear Stearns: What's the Difference", *Cato Institute*, (2008), <www.cato.org/pub_display.php?pub_id=9665>

³⁸⁹ House of Commons, "Banking Crisis: dealing with the failure of the UK banks", (2009), <<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf>>

³⁹⁰ *Ibid*

³⁹¹ Berger, A.N., & Bouwman, C.H.S., "How does capital affect bank performance during financial crises?", *Journal of Financial Economics*, 109, (2013): 146-176.

³⁹² *Ibid*

firms.³⁹³ Numerous businesses collapsed leaving to spike in unemployment, lowering of production, reduction in market demand and finally sustained economic.³⁹⁴

3.2.7 Monetary Policy Theories of the Credit Crisis

Extensive research has taken place on the motivators and reasons for the global financial crisis; such research revealed that the sustained use of unsuitable monetary and economic strategies by the government of the United States was undoubtedly responsible for the development of an environment that encouraged the creation of a substantial economic bubble, followed by an economic crash.³⁹⁵ Assenmacher-Wesche and Erlach stated that the elimination of the “Glass-Steagall” separation between commercial and investment banking operations could be considered to be an important driver of banking crisis.³⁹⁶ The removal of the “Glass-Steagall” wall in 1999 helped the diversion of savings into dangerous and high-risk investment opportunities and to the generation of unreal and overly hopeful expectations for enhancement of profitability and performance in the banking sector.³⁹⁷

The International Monetary Fund (IMF) made the point that whilst the years preceding 2007 were characterised by very low levels of interest, this period also saw the occurrence of significant and pertinent global.³⁹⁸ The constantly growing deficit in the American current account was by and large matched by the generation of current account surpluses in China and other developing economies.³⁹⁹ The reduction in interest rates by the Federal Reserve led to availability of substantial and cheap funds with numerous banks and investment companies as well as the growth of swap lines between the US Federal Reserve and the central banks of other countries.⁴⁰⁰⁴⁰¹

³⁹³ Barth, J., Caprio, G., & Levine, R., “Bank Regulation and Supervision in 180 Countries from 1999 to 2011,” *Journal of Financial Economic Policy*, 5, 2, (2013): 111-219.

³⁹⁴ *Ibid*

³⁹⁵ Tobias, A., & Shin, H.S., “*Financial Intermediaries and Monetary Economics*”, Chapter 12 in Handbook of Monetary Economics 3, eds. (Benjamin Friedman and Michael Woodford, pp. 601–650. Amsterdam: North-Holland, 2011).

³⁹⁶ Assenmacher-Wesche, K., & Gerlach, S., “Monetary Policy and Financial Imbalances: Facts and Fiction”, *Economic Policy*, 25, 63, (2010): 437–482.

³⁹⁷ Hair, J.F., Sarstedt, M., Hopkins, L., & Kuppelwieser, V.G., “Partial least squares structural equation modeling (PLS-SEM): An emerging tool in business research”, *European Business Review*, 26, 2, (2014): 106- 121.

³⁹⁸ Bean, C., Paustian, M., Penalver, A., & Taylor, T., “Monetary Policy after the Fall.” In *Macroeconomic Challenges: The Decade Ahead*, 2010 Economic Policy Symposium Proceedings, (Federal Reserve Bank of Kansas City, 2010).

³⁹⁹ Bernanke, S.B., “*Monetary Policy and the Housing Bubble*,” speech given at the annual meeting of the American Economic Association, Atlanta Georgia, (2010), <<http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm>>

⁴⁰⁰ Huang, X., Zhou, H., & Zhu, H., “A framework for assessing the systemic risk of major financial institutions”, *Journal of Banking and Finance*, 33, 11, (2009): 2036–2049.

⁴⁰¹ Jean, B., Lane, T., & Meh, C., “Should Monetary Policy Be Used to Counteract Financial Imbalances?”, *Bank of Canada Review*, (2010): 23-36.

3.2.8 Regulatory Failures

There is wide agreement amongst financial experts and researchers on the role of insufficient regulatory action in the development of the banking and financial crisis, particularly so in the oversight of new financial tools and instruments.⁴⁰² Regulators and policy makers in the USA and other western economies were motivated by low default rates and forcefully supported the moderation of regulation; they also disregarded the role of new financial innovations in the destabilisation of the banking sector.⁴⁰³ It is of course necessary to keep in mind that the intricacy of these tools along with the complicatedness of interrelated international markets made it challenging for regulators and policy makers to understand the various implications, specifically so with regard to risk.⁴⁰⁴ US, British and West European regulators mistakenly felt that markets finally engaged in suitable quantification and pricing of risks.⁴⁰⁵ They additionally felt that global markets could by and large self-correct in order to manage and control risks.⁴⁰⁶ Such convictions amongst regulators and legislators in fact facilitated bank managements in increasing their leverage to unsustainable levels.⁴⁰⁷

Research has now revealed that the risk control mechanisms being utilised by banks were essentially wrong and grounded in insufficient appreciation of finance theory and practice.⁴⁰⁸ Bankers for example felt that the use of the new financial instruments was likely to result in the secure and widespread dissemination of banking risks.⁴⁰⁹ They could not in fact evaluate the risks that entrenched themselves in the system because of increased leverage.⁴¹⁰

⁴⁰² Calomiris, C., & Haber, S., *Fragile by Design: Banking Crises, Scarce Credit, and Political Bargains*, (Princeton: Princeton University Press, 2014).

⁴⁰³ Acharya, V. V., Schnabl, P., & Suarez, G., “*Securitization Without Risk Transfer*,” Working Paper, (New York: University Stern School of Business, 2009).

⁴⁰⁴ Brunnermeier, M.K., “*Liquidity Credit Crunch*”, (2009),

<http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf>

⁴⁰⁵ *Ibid*

⁴⁰⁶ Gorton, G., “*Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*,” (Working Paper: Yale University, 2009).

⁴⁰⁷ *Ibid*

⁴⁰⁸ Brunnermeier, M.K., “*Liquidity Credit Crunch*”, (2009),

<http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf>

⁴⁰⁹ Barth, J., Caprio, G., & Levine, R., “Bank Regulation and Supervision in 180 Countries from 1999 to 2011,” *Journal of Financial Economic Policy*, 5, 2, (2013): 111-219.

⁴¹⁰ Calomiris, C., & Herring, R., “How to Design a Contingent Convertible Debt Requirement that Solves Our Too-Big-To-Fail Problem,” *Journal of Applied Corporate Finance*, 25, 2, (2013): pp. 1-19.

Several banks furthermore introduced remuneration strategies that provided high bonuses to managers for achievement of short term business gains.⁴¹¹ The desire to earn bonuses motivated bank managers to hide high risk strategies and operations with the use of unclear terminology and intentional bluff and bravado.⁴¹² Market discipline, considered by many to be the best manager of risk, was found to be of little use in an environment of fiscal imprudence and excessive risks.⁴¹³ Several problems and insufficiencies entered into the strategising and decision making of banks, leading in turn to substantial insufficiencies in the comprehension of the risks assumed by banks.⁴¹⁴

Acharya *et al.*, stated that the regulations that were in place before the onset of the crisis were obsolete and not in accordance with recent developments in the global banking environment.⁴¹⁵ Such deficiencies helped bank managements to cover the high levels of their organisational risks from regulatory oversight with the help of various tools and techniques, more specifically SPVs, off-balance sheet working, foreign financial centres and derivatives.⁴¹⁶ American and West European regulators failed to estimate the extent of risks in their financial frameworks or in fact to comprehensively understand the character of systemic risk and the development of large scale risk exposure on account of the use of SPVs.⁴¹⁷ Policy makers and regulators also revealed very little interest in the oversight of enhanced banking leverage.⁴¹⁸ Bank managements were in fact asked to formulate and implement their own risk management systems, which gave them the confidence to increase their risk exposure.⁴¹⁹

⁴¹¹ Blundell, A., Blundell, W., & Atkinson, P., "The Sub-Prime Crisis: Causal Distortions and Regulatory Reform," in Paul Bloxham and Christopher Kent, eds., *Lessons from the Financial Turmoil of 2007 and 2008*, (Reserve Bank of Australia, 2008).

⁴¹² *Ibid*

⁴¹³ *Ibid*

⁴¹⁴ Beltratti, A., & Stulz, R.M., "The credit crisis around the globe: Why did some banks perform better?," *Journal of Financial Economics*, 105, 1, (2012): 1-17.

⁴¹⁵ Acharya, V. V., Schnabl, P., & Suarez, G., "*Securitization Without Risk Transfer*," Working Paper, (New York: University Stern School of Business, 2009).

⁴¹⁶ *Ibid*

⁴¹⁷ Barth, J., Caprio, G., & Levine, R., "Bank Regulation and Supervision in 180 Countries from 1999 to 2011," *Journal of Financial Economic Policy*, 5, 2, (2013): 111-219.

⁴¹⁸ Calluzzo, P., & Dong, G.N., "Has the financial system become safer after the crisis? The changing nature of financial institution risk," *Journal of Banking and Finance*, 53, (2015): 233-248.

⁴¹⁹ *Ibid*

3.2.9 Role of Credit Rating Agencies

Credit Rating (CR) Agencies appear to have played an important role in the development of the subprime crisis. CRAs play very important roles in present day banking and finance.⁴²⁰ Their statements and reports are felt to be credible and are often used in preference to internal due diligence.⁴²¹ Well known CRAs like Standards and Poor and Moody's were in fact mistaken in their understanding of the risk elements of SPVs and did not provide sufficient precautionary warnings to investors or regulators.⁴²² Lehman Brother's CRA in fact did not provide any precautionary statements or signals about the high level of risk of the firm's strategies and position even though its leverage was more than 30.⁴²³

3.2.10 Market Discipline Argument

Market discipline refers to the discipline that competitive markets impose upon firms operation in ideal conditions to adopt governance procedures that result in maximisation of shareholder value.⁴²⁴ Firms that do not engage in such behaviour are likely to face penalties in the form of higher financing costs and lower profitability.⁴²⁵ Inefficient or wayward firms are likely to be ultimately forced out of business or taken over by other firms.⁴²⁶ Market discipline ideally comes into play as soon as firms start going astray and markets provide signals and incentives to managements, well in time to take corrective action.⁴²⁷

Substantial literature exists on the issue of market discipline, with particular regard to banking and financial institutions.⁴²⁸ Two aspects have been specifically emphasised with regard to the market discipline of banks, namely (1) the pricing of default risk and (2) corporate

⁴²⁰ Glasserman, P., & Young, H.P., "How likely is contagion in financial networks?", *Journal of Banking and Finance*, 50, (2015): 383-399.

⁴²¹ Chabanel, P-E, "Implementing Basel iii: challenges, Options & Opportunities", *Moody's Analytics*, (2011), <http://www.moodysanalytics.com/~media/Insight/Regulatory/Basel-III/Thought-Leadership/2011/11-01-09-Implementing-Basel-III-Whitepaper.ashx> >

⁴²² Blundell, A., Blundell, W., & Atkinson, P., "The Sub-Prime Crisis: Causal Distortions and Regulatory Reform," in Paul Bloxham and Christopher Kent, eds., *Lessons from the Financial Turmoil of 2007 and 2008*, (Reserve Bank of Australia, 2008).

⁴²³ *Ibid*

⁴²⁴ Nal, O., "Strategic Behaviors in Financial Markets and the Market discipline Mechanism", (working paper, Rice University, 2006).

⁴²⁵ Calomiris, C., & Kahn, C.M., "The Role of Demandable Debt in Structuring Optimal Banking Arrangements", *American Economic Review*: (1991): 497-513.

⁴²⁶ Demircuc-kunt, A., & Huizinga, H., "Deposit Insurance and Market Discipline", *Journal of Monetary Economics*, 51, 2, (2004): 1-19.

⁴²⁷ Goyal, V. K., "Market Discipline of Bank Risk: Evidence from Subordinated Debt Contracts", *Journal of Financial Intermediation*, 14, (2005): 318-350.

⁴²⁸ Flannery, M. J., & Sorescu, S.M., "Evidence of Bank Market Discipline in Subordinated Debenture Yields: 1983-1991", *The Journal of Finance*, 51, 4, (1996): 1347-77.

governance.⁴²⁹ With regard to the first aspect, it is commonly known that the limited liability of the shareholders of corporations results in the motivation and incentivisation amongst the organisational management to shift risks to creditors; such incentives intensify when equity capital is not high.⁴³⁰ The creditors of corporations thus have incentives for monitoring of default risks and loss given default and consequently to demand compensation for such risk.⁴³¹

The credit risk premium is largely perceived as the premium on a put option on the assets of a corporation that are bought by shareholders with a strike price that is by and large equal to the value of total debt.⁴³² Shareholders thus have incentives to increase intake of relatively low cost borrowings and enhance default risks at the expense of debt holders when the credit risk premium on the debt of a corporation is too low.⁴³³ Market discipline requires that the funding costs of a financial institution should reflect risk taking with regard to probability of default.⁴³⁴

The management of the financial institution should also react appropriately to the data provided by the costs of dissimilar funding sources. The management of an institution operating in well-functioning markets would select asset and liability positions that increase shareholder value.⁴³⁵ With regard to corporate governance, the corporate governance structure of institutions must motivate managements to maximise shareholder value for market discipline to be effective.⁴³⁶

These two facets of market discipline are often known as direct market discipline in relevant literature.⁴³⁷ Indirect market discipline on the other hand is concerned with the utilisation of price signals with regard to the risk being made use of by supervisors as indicators that can trigger off intervention.⁴³⁸

⁴²⁹Gonzalez, F., "Bank Regulation and Risk-Taking Incentives: An International Comparison of Bank Risk", *Journal of Banking and Finance*, 29: (2005): 1153-84.

⁴³⁰*Ibid*

⁴³¹Demirguc-kunt, A., & Huizinga, H., "Deposit Insurance and Market Discipline", *Journal of Monetary Economics*, 51, 2, (2004): 1-19.

⁴³²Nal, O., "Strategic Behaviors in Financial Markets and the Market discipline Mechanism", (working paper, Rice University, 2006).

⁴³³*Ibid*

⁴³⁴Goyal, V. K., "Market Discipline of Bank Risk: Evidence from Subordinated Debt Contracts", *Journal of Financial Intermediation*, 14, (2005): 318-350.

⁴³⁵Flannery, M. J., & Sorescu, S.M., "Evidence of Bank Market Discipline in Subordinated Debenture Yields: 1983-1991", *The Journal of Finance*, 51, 4, (1996): 1347-77.

⁴³⁶*Ibid*

⁴³⁷Demirguc-kunt, A., & Huizinga, H., "Deposit Insurance and Market Discipline", *Journal of Monetary Economics*, 51, 2, (2004): 1-19.

⁴³⁸*Ibid*

Direct market discipline can often fail in the financial sector for reasons associated with regulation of risk taking and supervision.⁴³⁹ Creditors may for example be unable to obtain information to evaluate the riskiness of financial institutions.⁴⁴⁰ The opacity of banks has often been mentioned in arguments for supervision of banks on the assumption that appointed supervisors be in a better position to obtain the information needed for evaluation of risk.⁴⁴¹ The second argument for failure of market discipline stems from the explicit or implicit protection of creditors from losses in case of default.⁴⁴² The explicit insurance of depositors of bank lowers their motivation both to monitor the working of banks and to ask for a risk premium on deposits.⁴⁴³ Implicit insurance on the other hand comes into play when the creditors of a financial institution expect to be protected during insolvency because the institution is felt to be too big to fail and a government blanket guarantee is expected to be forthcoming in times of distress.⁴⁴⁴ The presence of both explicit and implicit creditor insurance motivates financial institutions to assume too much debt and to thereby move default risk to deposit insurance companies or to tax payers.⁴⁴⁵

The financial crisis of 2008-2010 has been attributed to poor levels of corporate governance; compensation schemes for executives, risk managers and traders have motivated them to engage in excessive risk taking.⁴⁴⁶ It must also be kept in mind that the default of one financial institution can have systemic implication for others.⁴⁴⁷ The potential systemic risk of the failure of a financial institution provides the rationale for regulation and supervision at a macro level.⁴⁴⁸

⁴³⁹Gonzalez, F., "Bank Regulation and Risk-Taking Incentives: An International Comparison of Bank Risk", *Journal of Banking and Finance*, 29: (2005): 1153-84.

⁴⁴⁰*Ibid*

⁴⁴¹*Ibid*

⁴⁴²Calomiris, C., & Kahn, C.M., "The Role of Demandable Debt in Structuring Optimal Banking Arrangements", *American Economic Review*: (1991): 497-513.

⁴⁴³*Ibid*

⁴⁴⁴*Ibid*

⁴⁴⁵Nal, O., "Strategic Behaviors in Financial Markets and the Market discipline Mechanism", (working paper, Rice University, 2006).

⁴⁴⁶Copland, J.R., & O'Keffee, M.M., "A Report on Corporate Governance and Shareholder Activism", (2014),

<http://www.proxymonitor.org/Forms/pmr_09.aspx>

⁴⁴⁷Sun, W., *How to Govern Corporations So They Serve the Public Good: A Theory of Corporate Governance Emergence*, (New York: Edwin Mellen, 2010).

⁴⁴⁸*Ibid*

4 Critical Review of Islamic Finance Products and Theory

4.1.1 Standardisation of Sharia Principles in Islamic Banking and Finance

There is little doubt that the practice of Islamic finance has developed from simple and elementary retail banking to a complex and wide ranging banking service with a broad range of banking products and services.⁴⁴⁹ Islamic finance has not only proliferated across the world, especially Asia, Africa and Europe but has also developed into a truly alternative banking system.⁴⁵⁰ Islamic banking has to comply with Sharia principles; this is a clear dictum and cannot be compromised or moderated in anyway. The need for ensuring Sharia compliance across banks was minimal in the early days of Islamic banking on account of comparatively elementary banking practices and restricted operations.⁴⁵¹ The early stage of Islamic finance involved the transformation of theoretical ideas and concepts into practical application, which had to be adequate for modern day banking needs in order to be adopted by customers.⁴⁵²

The growth and evolution of Islamic financing has resulted in the development of several complex generations of finance, models and instruments as well as Islamic finances entry into capital market centres.⁴⁵³ Islamic finance products and services have become complex and are often modified and moderated by individual Islamic banks in order to cater to the needs of their customers.⁴⁵⁴ Ahmed stated that the safeguarding of Sharia compliance is essential for Islamic finance to assume a greater role in global financial markets.⁴⁵⁵ He added that the complexity of Islamic financial products was however making it increasingly difficult to ensure Sharia compliance, with regard to both products and institutions.⁴⁵⁶ The complexity of products and services calls for careful attention and study, not just in the formulation of specific contracts but also in all other areas of actual application.⁴⁵⁷ It also had to be kept in mind that Sharia

⁴⁴⁹ Venardos, A. M., *Islamic Banking and Finance in South-East Asia: Its Developments and Future World*, (USA: Scientific Publishing Co Pte Ltd, 2006).

⁴⁵⁰ Hasan, Z., *Sharia Governance in Islamic Banks*, (Edinburgh: Edinburgh University Press Ltd, 2012).

⁴⁵¹ Tannenbaum, M.G., "*Principles of Islamic Finance: Global Note Special focus report*", (USA: Tannenbaum Helpert Syracuse & Hirschritt LLP, 1998).

⁴⁵² Rahman, A., "*Shar'ah audit for Islamic financial services: the need and challenges*," (ISRA Islamic Finance Seminar: Kuala Lumpur, 2008).

⁴⁵³ Susan, F., "The efficiency of Islamic banking industry: a non-parametric analysis with non-discretionary input variable", *Islamic Economic Studies*, 14, 1&2, (2006): 54-87.

⁴⁵⁴ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

⁴⁵⁵ Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, 39, (2010): pp. 36-45.

⁴⁵⁶ *Ibid*

⁴⁵⁷ Schoon, N., *Islamic banking and finance*, (London: Spiramus press Ltd, 2009).

compliance was a continuous process that called for constant attention and oversight, the development and deployment of appropriate and effective mechanisms and trained and competent human resources.⁴⁵⁸ Many contemporary scholars feel that the harmonisation, regulation and supervision of Sharia constitute one of the most important elements of Islamic finance.⁴⁵⁹ Siddiqi stated that greater clarity, with regard to the standardisation and development of Islamic finance instruments would have helped it in assuming a greater role in contemporary society.⁴⁶⁰ A number of issues are at present creating difficulties in the standardisation of Islamic products.⁴⁶¹ The status quo is characterised by the following factors.

- Different Islamic banks offer different products; some of these are deemed unlawful by other Islamic banks.
- The Sharia procedures of the same product differ amongst Islamic banks because of conflict in legal opinions of Islamic scholars.⁴⁶²

“Standardisation in the Islamic finance industry compares very badly with the conventional finance industry. While many commercial terms still need to be negotiated between the principals, the existence of standard documentation which the lawyers acting for both parties will use as their starting point significantly reduces the cost of creating "big-ticket" conventional bank lending. There is nothing equivalent in the Islamic finance industry. While the work of AAOIFI has been very helpful in standardising Sharia interpretation, there is still significant scope for disagreement between the Sharia advisers acting for the provider of finance and those acting for the recipient. Much more needs to be done in promulgating further AAOIFI Sharia Standards.”⁴⁶³

Moore and Bianchi stated that people around the world are looking at Islamic finance to ease the monetary and financial pressures that have been created by the economic and financial

⁴⁵⁸ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

⁴⁵⁹ Ausaf, A., “Islamic Banking in the Informal Sector: Interest-free Solutions in Non-Muslim Societies”, *Review of Islamic Economics*, 14 (2003): 67-92.

⁴⁶⁰ Siddiqi, M.N., “Current Financial Crisis and Islamic Economics”, *Radiance Views weekly*, 38, (2009), <<http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable-Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html>>

⁴⁶¹ Amin, A., “*How industry standardisation in Islamic finance could help promote cross-border transactions*”, (2012), <http://www.mohammedamin.com/Islamic_finance/Industry-standardisation-and-cross-border-Islamic-finance.html>

⁴⁶² *Ibid*

⁴⁶³ *Ibid*

crisis of 2008.⁴⁶⁴⁴⁶⁵ It was thus important to safeguard Sharia compliance in order to ensure greater contribution by Islamic finance to global society.⁴⁶⁶ Islamic finance could in fact be promoted only if Sharia compliance was properly defined.⁴⁶⁷ The formulation of Sharia rules for Islamic finance falls in the realm of Sharia scholars.⁴⁶⁸ It is however important to investigate the exact role of scholars in standardisation and harmonisation of Sharia standards and the implementation of Sharia governance mechanisms.⁴⁶⁹ It was also equally important to discuss the roles of business professionals and regulators in this process.⁴⁷⁰

Market leaders and regulators have frequently called for the harmonisation of Sharia standards to bring about growth and stability for the Islamic banking and finance sector.⁴⁷¹ These two expert groups have informed that the development of defined Sharia standards would assist in the formulation of regulatory judgements and result in well-defined and clear regulatory oversight for the sector.⁴⁷² This in turn would result in greater stability and more nurture and expansion and growth.⁴⁷³ These experts argued that absence of clarity and continued confusion in Sharia practices would conversely result in lesser mobility of these practices, both within countries and across borders, which in turn handicap industry growth.⁴⁷⁴

El-Gamal stated that Sharia compliance was characteristically a dynamic process that called for practice; it did not comprise only rulings but also incorporated practices that called for exercise and application.⁴⁷⁵ The absence of uniformity in Sharia standards was likely to make it difficult and challenging for the defining of appropriate and universal compliance practices.⁴⁷⁶ Chong and Ming-Hua and Susan stated that harmonisation of Sharia standards was likely to result in reduction in transaction costs for the Islamic finance sector, assist the

⁴⁶⁴ Moore, E., *The International Handbook of Islamic Banking and Finance*, (Cranbrook: Global Professional Publishing, 2009).

⁴⁶⁵ Bianchi, R. R., "The Revolution in Islamic Finance", *Chicago Journal of International Law*, Vol. 7, 2, (2007): 569-581.

⁴⁶⁶ Moore, E., *The International Handbook of Islamic Banking and Finance*, (Cranbrook: Global Professional Publishing, 2009).

⁴⁶⁷ Bianchi, R. R., "The Revolution in Islamic Finance", *Chicago Journal of International Law*, Vol. 7, 2, (2007): 569-581.

⁴⁶⁸ Kutty, F., "*Banking on Faith: Conference on Islamic Banking and Finance*", (The Washington Report on Middle East Affairs, XIV, 40, 1995).

⁴⁶⁹ Chong, B. S., & Ming-Hua, L., "Islamic banking: Interest-free or interest-based", *Pacific-Basin Finance Journal*, 17, 1, (2009): 125-144.

⁴⁷⁰ *Ibid*

⁴⁷¹ El-Gamal, M.A., "Can Islamic Banking Survive, A Micro- Evolutionary Perspective", *Social System Research Institute Working Paper*, (University of Wisconsin, Madison: USA, 1997).

⁴⁷² Kahf, M., "*Strategic Trends in the Islamic Banking and Finance movement: The Harvard forum on Islamic Finance and Banking*", (Harvard University: Boston, 2002).

⁴⁷³ Iqbal, Z., & Mirakhor, A., "Progress and Challenges of Islamic Banking", *Thunderbird International Business Review*, 3, (1999): 381-403.

⁴⁷⁴ Gavin, J., Gibson, N., McCrum, P., & Summers, M., "Annual Review of Islamic Banking and Finance", *Hilal Publications*, (2010), <thegulfonline.com/source/IslamicBankingReview.pdf>

⁴⁷⁵ El-Gamal, M., *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University, Houston: USA, 2000).

⁴⁷⁶ *Ibid*

development of efficient and effective regulatory oversight, augment the Sharia compliance process and increase confidence and growth in the sector.^{477,478}

Sharia scholars on the other hand have somewhat dissimilar opinions and feelings about the development of complete harmonisation in Sharia standards.⁴⁷⁹ Some of them have expressed apprehensions that Sharia standardisation may oppose the basic premises of Ijtihad, which have come down over the centuries.⁴⁸⁰ Ijtihad comprises the detailed process of narrowing and reducing Sharia rules from their genuine forces.⁴⁸¹ The process is continuous and is utilised by the highest level of experts in Sharia.⁴⁸² It is thus apprehended that the standardisation of rules and their imposition by legal authorities may result in the obsolescence and non-applicability of the Ijtihad.⁴⁸³ The progressive irrelevance of Ijtihad may damage the premises for application of Sharia in different places and times; Ijtihad is the main driver of the dynamism and flexibility of Sharia and its applicability in various situations.⁴⁸⁴

Aggarwal and Yousef furthermore stated that Sharia comprises different schools of thought; these schools frequently differ in their thoughts, feelings and opinions on various issues even though they continue to concur on important issues.⁴⁸⁵ The standardisation of Sharia ruling could result in the dominance of particular schools and impede harmonisation.⁴⁸⁶

It is evident that market regulators and business practitioners are likely to differ in their perceptions on Sharia harmonisation with Sharia experts.⁴⁸⁷ Whilst harmonisation of Sharia standards is considered to be a necessary precedent for its international expansion, such harmonisation has to be brought about by Sharia scholars, rather than regulators and market professionals.⁴⁸⁸ Sharia scholars are essentially specialised in their knowledge and expertise on

⁴⁷⁷ Chong, B. S., & Ming-Hua, L., "Islamic banking: Interest-free or interest-based", *Pacific-Basin Finance Journal*, 17, 1, (2009): 125-144.

⁴⁷⁸ Susan, F., "The efficiency of Islamic banking industry: a non-parametric analysis with non-discretionary input variable", *Islamic Economic Studies*, 14, 1&2, (2006): 54-87.

⁴⁷⁹ Schoon, N., *Islamic banking and finance*, (London: Spiramus press Ltd, 2009).

⁴⁸⁰ *Ibid*

⁴⁸¹ Saiful, R., *Critical issues on Islamic banking and financial markets*, (USA: Author House, 2005).

⁴⁸² Ausaf, A., "Islamic Banking in the Informal Sector: Interest-free Solutions in Non-Muslim Societies", *Review of Islamic Economics*, 14 (2003): 67-92.

⁴⁸³ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

⁴⁸⁴ *Ibid*

⁴⁸⁵ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

⁴⁸⁶ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

⁴⁸⁷ Hasan, Z., *Sharia Governance in Islamic Banks*, (Edinburgh: Edinburgh University Press Ltd, 2012).

⁴⁸⁸ *Ibid*

the subject and are best equipped to decide the standardisation or otherwise of a Fatwa.⁴⁸⁹ Al-Omar and Abdel-Haq stated that Sharia supervisory boards could play a significant role in standardisation of Sharia rules.⁴⁹⁰ A Sharia Supervisory Board (SSB) in a country makes use of appropriate governance measures to ensure that firms comply with Islamic law and guidelines. The members of these boards are generally Sharia scholars with extensive knowledge.⁴⁹¹ Rahman stated that standardisation of Sharia norms was important because different Islamic banks offered dissimilar products; some of these products were deemed unlawful by other Islamic banks.⁴⁹² It also had to be kept in mind that the Sharia procedures of the same products could also differ from Islamic bank to other Islamic bank.⁴⁹³ Such differences in opinions amongst Sharia scholars was not only putting the credibility of Islamic banks at risk but also resulting in interbank disputes that were difficult to solve and the creation of problems for syndicated finance with other Islamic bank.⁴⁹⁴ Absence of standardisation had in fact resulted in the creation of an absolutely new banking risk, i.e. the Sharia risk. Absence of standardisation was not only deterring development but also resulting in a negative image for Islamic banking.⁴⁹⁵

Hasan stated that standardisation could be brought about by the joint efforts of international Islamic legal bodies, Islamic law academies and the AAOIFI (Auditing and Accounting Organisation for Islamic Financial Institution) and CIBAFI (Council for Islamic Banking and Financial Institution).⁴⁹⁶ It was necessary to educate both Islamic and central banks about the imperative need for standardisation in order to generate sustainable success and credibility.⁴⁹⁷ The summarisation of the opinions of Sharia scholars led to the identification of several challenges and solutions.⁴⁹⁸ Such challenges could arise from conflict of interest, standardisation not being beneficial for the Sharia supervisor and fears of less likelihood of jobs.⁴⁹⁹ Difficulties could also arise from the rigid dogmas and fanaticism about fiqh schools or

⁴⁸⁹ *Ibid*

⁴⁹⁰ *Ibid*

⁴⁹¹ Rahman, A., "Shar'ah audit for Islamic financial services: the need and challenges," (ISRA Islamic Finance Seminar: Kuala Lumpur, 2008).

⁴⁹² *Ibid*

⁴⁹³ Moore, E., *The International Handbook of Islamic Banking and Finance*, (Cranbrook: Global Professional Publishing, 2009).

⁴⁹⁴ *Ibid*

⁴⁹⁵ Iqbal, Z., & Mirakhor, A., "Progress and Challenges of Islamic Banking", *Thunderbird International Business Review*, 3, (1999): 381-403.

⁴⁹⁶ Hasan, Z., *Sharia Governance in Islamic Banks*, (Edinburgh: Edinburgh University Press Ltd, 2012).

⁴⁹⁷ *Ibid*

⁴⁹⁸ Gavin, J., Gibson, N., McCrum, P., & Summers, M., "Annual Review of Islamic Banking and Finance", *Hilal Publications*, (2010), <thegulfonline.com/source/IslamicBankingReview.pdf>

⁴⁹⁹ *Ibid*

lack of agreement on the standards on which product had to be standardised.⁵⁰⁰ Such standardisation could be developed through careful selection of the involved scholars, providing scholars with appropriate independence and endorsing their standards by fiqh academies.⁵⁰¹

Standardisation was also likely to result in legal challenges but could stem from possible differences with local laws.⁵⁰² There seems to be wide agreement that standardisation would bring about some extremely important benefits.⁵⁰³ These are elaborated below.

- Sound Public Reputation and Image
- Reduction and elimination of Sharia Risks
- Reduction of Costs
- Reduction of legal difficulties
- Significantly greater cooperation between Islamic banks
- Furtherance of universality in Islamic banking⁵⁰⁴

4.1.2 **Control of Islamic Banks by Central Banks**

The tools of monetary policy occupy an extremely important place in market driven economies.⁵⁰⁵ Whilst such tools are supposed to be dissimilar in markets that are also host to Islamic banks, some monetary authorities do not appreciate such differences.⁵⁰⁶

The existing supervisory system, in the context of Islamic banks tends to be inefficient and ineffective on account of the absence of a suitable supervisory framework.⁵⁰⁷ The central banks of several countries have assumed the responsibility of supervising Islamic banks but with the use of the same tools that are used for conventional banks.⁵⁰⁸ Problems however arise on account of the different contractual relationships between Islamic banks and their depositors and

⁵⁰⁰ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

⁵⁰¹ *Ibid*

⁵⁰² Venardos, A. M., *Islamic Banking and Finance in South-East Asia: Its Developments and Future World*, (USA: Scientific Publishing Co Pte Ltd, 2006).

⁵⁰³ Gavin, J., Gibson, N., McCrum, P., & Summers, M., "Annual Review of Islamic Banking and Finance", *Hilal Publications*, (2010), <thegulfonline.com/source/IslamicBankingReview.pdf>

⁵⁰⁴ *Ibid*

⁵⁰⁵ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁵⁰⁶ *Ibid*

⁵⁰⁷ Visser, H., *Islamic finance: principles and practice*, (London: Routledge Publishers, 2013).

⁵⁰⁸ *Ibid*

the financing methods.⁵⁰⁹ Central banks in such circumstances use tools like liquidity ratios and reserve requirements for safeguarding of depositor money, taking account of all deposits.⁵¹⁰ This is however not the case in Islamic banks, except for current accounts. Investment account holders of Islamic banks need to additionally be protected from losses but this is not clearly spelled out in the Sharia.⁵¹¹

It is thus necessary that very well thought out and suitable policies be adopted by Islamic banks.⁵¹² Islamic banks have to maintain specific reserves with central banks in order to satisfy unexpected withdrawals and protect deposits in cases of liquidation.⁵¹³ Investment deposits are however not allowed to be withdrawn before maturity dates and do not have guaranteed returns; it is conceptually not thus necessary to maintain reserves in case of these reasons.⁵¹⁴ It is important to appreciate that the relationship between Islamic and central banks is as of now based upon coexistence and compromise of the background of ambiguity from the Sharia perspective.⁵¹⁵ Sullivan and Sheffrin stated that the decision to engage in interim solutions may not truly be effective until and unless they were associated with practical procedures and the restructuring of the banking system.⁵¹⁶

4.1.3 **Overview of Islamic Banking**

Islamic banking activity comprises banking and financing operations that basically complies with the tenets of Islam, as elaborated through religious texts like the Quran, the Sharia and the Sunnah and is logically operationalised through the use of Islamic economic practice.⁵¹⁷

The origin of Islamic banking and finance goes back to the Prophet Mohammed.⁵¹⁸ Mohammed was essentially a man of business, who was respected across society for his emphasis on fairness in trade.⁵¹⁹ The prophet's approach towards charging of interest was widely known. Several individuals, including traders, kept their money in his custody.⁵²⁰

⁵⁰⁹ *Ibid*

⁵¹⁰ Susan, F., "The efficiency of Islamic banking industry: a non-parametric analysis with non-discretionary input variable", *Islamic Economic Studies*, 14, 1&2, (2006): 54-87.

⁵¹¹ *Ibid*

⁵¹² Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁵¹³ *Ibid*

⁵¹⁴ *Ibid*

⁵¹⁵ *Ibid*

⁵¹⁶ Sullivan, A., & Sheffrin, S.M., *Economics: Principles in action*, (Upper Saddle River: Pearson Prentice Hall, 2003).

⁵¹⁷ Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, Vol.39 (2010): pp. 36.

⁵¹⁸ *Ibid*

⁵¹⁹ *Ibid*

⁵²⁰ *Ibid*

Modern Islamic banking actually originated in 1963 with the commencement of a savings bank, founded in Egypt by Ahmed El Najjar.⁵²¹ The setting up of this bank resulted in establishment of many other banking institutions in Egypt in subsequent years. All these establishments did not charge or take interest, even though they worked extensively with business people, trade and industry.

Bianchi informed that Islamic banking activity has in a period of a few years grown into an important optional banking channel compared to the traditional banking services provided by conventional banks and financial institutions across the world.⁵²² The steady growth in Islamic banking activity and its adoption by several traditional banks (which have started providing additional Islamic banking services) has resulted in adding to the growth of the activity and the assets and revenues of Islamic banks.⁵²³ The cumulative funds invested in the Islamic banking sector have exceeded a trillion dollars; the growth in customer demand for Islamic banking services has prompted many traditional western bankers to open Islamic banking windows and provide a range of services including diverse Islamic investment options to their customers.⁵²⁴ Large traditional banks like the Citi Groups, Lloyds, HSBC, the Saudi British Bank and the Saudi American bank have created and are providing several Islamic banking options, services and products to the bank going public.⁵²⁵

As previously explained Islamic banking diverges from traditional banking with specific regard to the impact of religion. Traditional banking activities operate in compliance with common law and are basically founded in receiving and charging of interest from clients, i.e. depositors and borrowers. El-Gamal stated that the Islamic religion prohibits interest in all activities; this approach towards interest has resulted in the generation of a unique and distinct Islamic banking activity that focuses upon cooperative and associative relationships and working between the users and providers of finance, rather than the application of mechanisms that create specific arm's length distances between the two, as also the application of financing charges (Interest) and the protection of loaned monies with the use of hypothecated assets.⁵²⁶ The rapid expansion of Islamic banking is being driven to a large extent by its assistance from Muslims

⁵²¹ Lewis, M.K., "In what ways does Islamic banking differ from conventional finance?", *Journal of Islamic Economics, Banking and Finance*, 4, 3 (2008): 4-6.

⁵²² Bianchi, R. R., "The Revolution in Islamic Finance", *Chicago Journal of International Law*, Vol. 7, 2, (2007): 569-581.

⁵²³ *Ibid*

⁵²⁴ *Ibid*

⁵²⁵ *Ibid*

⁵²⁶ El-Gamal, M., *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University, Houston: USA, 2000).

across the world, more so in the Middle East, North Africa, and the GCC nations, Pakistan, Indonesia and Malaysia.⁵²⁷The activity is also expected to increase steadily in the USA on account of the large Muslim population in the country.⁵²⁸Banks in London have, in fact, been offering Islamic banking and financial services since the mid-1980s.⁵²⁹The activity has been actively supported by the UK government, which has helped in the formulation of attractive Islamic banking products for UK customers.⁵³⁰

4.1.4 **Unique Characteristics of Islamic Banking**

Askari *et al.*, informed that western and Islamic banking systems have several inherent dissimilarities in their basic tenets, which, in turn, have resulted in the creation of significantly different banking strategies, policies and practices.⁵³¹ Western banking traces its origins to the 14th century, when it was developed in the Italian merchant towns of Venice and Genoa; it has since then grown steadily over the centuries, responding and reacting to the needs of different types of capitalistic models.⁵³² The expansion of the western banking framework has, in addition, been considerably impacted and shaped by diverse regulatory and legal developments, along with the corresponding evolution and sophistication of the modern financial accounting system.⁵³³

Al-Omar and Abdel-Haq stated that whereas the majority of fiscal and banking policies and practices have grown and progressed in different countries and regions of their own volition, numerous similarities have occurred in the banking methods of different countries over the years, primarily because continuity in business and trade activities between different countries.⁵³⁴ The growth of modern banking practices has also been driven, first by the colonialism of the English, the French, the Dutch and other Europeans and subsequently by the financial and mercantile pre-eminence of western nations in global business activity.⁵³⁵ These factors have driven the establishment and growth of western banks across the world. The development and large-scale

⁵²⁷ *Ibid*

⁵²⁸ *Ibid*

⁵²⁹ *Ibid*

⁵³⁰ *Ibid*

⁵³¹ Askari, H., Iqbal, Z., Mirakhor, A., & Krichene, N., *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (John Wiley & Sons (Asia) P. Ltd. Singapore, 2010).

⁵³² *Ibid*

⁵³³ *Ibid*

⁵³⁴ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

⁵³⁵ *Ibid*

acceptance of the Basel accords since the 1980s have also helped significantly in the growth of western banking methods in different countries across the world.⁵³⁶

El-Gamal stated that Islamic banking and financial practices were influenced and shaped by Islamic law and tenets, namely the Sharia.⁵³⁷ These basic influencers of Islamic banking have stayed unchanged for many centuries and have assisted in the growth and formation of a long lasting and robust framework for the growth of Islamic banking and financial systems.⁵³⁸ Islamic legal principles, as expounded in the Sharia are essentially founded upon the contents of the Islamic holy book, the Quran and Sunnah of the prophet.⁵³⁹ Whereas the Quran provides the foundation for the Sharia, the Sunnah of the Prophet elaborates upon Islamic law through exposition of the likes, dislikes and feelings of the Prophet on various issues.⁵⁴⁰

Lewis made the point that the Sharia refers to the Ijmah in addition to these two sources. The Ijmah deals with harmony and accord as also the validation and evaluation of diverse contemporary issues by well-known and capable scholars of Islamic.⁵⁴¹ Assistance in this area is provided by the Quiyas, which deals with analogical analysis; the Quiyas helps in the application of the Sharia to diverse present day concerns and issues, especially when the analogies are concerned with similar issues.⁵⁴² It needs to be mentioned that the elaboration or re-explanation of diverse facets of Islamic law by competent and learned Islamic experts is known as the Ijtihad; this is also used to interpret Islamic legal issues in modern times.⁵⁴³

Khan & Bhatti made the point that the expansion of Islamic law had been driven and influenced by a number of complementary and comparable philosophies; these resulted in the establishment of diverse Islamic banking ideas, thinking and theories.⁵⁴⁴ Islamic law has provided details about four important business requirements, namely (1) the prohibition of the receiving or providing interest, (2) the proscription of business activities concerned with tobacco, liquor and drugs, (3) the ban on gambling and speculative activity and (4) the mandatory need for payment

⁵³⁶ *Ibid*

⁵³⁷ El-Gamal, M., *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University, Houston: USA, 2000).

⁵³⁸ *Ibid*

⁵³⁹ *Ibid*

⁵⁴⁰ *Ibid*

⁵⁴¹ Lewis, M.K., "In what ways does Islamic banking differ from conventional finance?", *Journal of Islamic Economics, Banking and Finance*, 4, 3 (2008): 4-6.

⁵⁴² *Ibid*

⁵⁴³ *Ibid*

⁵⁴⁴ Khan, M. M., & Bhatti, M. I., "Development in Islamic banking: a financial risk-allocation approach", *The Journal of Risk Finance*, 9, 1, (2008): 40-51.

of Zakat, a charge that should be distinguished from normal income tax and meant for benefiting underprivileged and deprived people.⁵⁴⁵

Ahmed informed that Islamic banking and finance policies and practices could be expected to differ substantially from conventional banking because of the prohibition of the charging or receiving of interest.⁵⁴⁶ Some Islamic laws focus upon the enforcing of boundaries on the operations that bank can make use of in the normal course of their operations or request the payment of additional levies; the prohibition on charging and receiving of interest however ensures that Islamic banking becomes basically dissimilar from commercial banking.⁵⁴⁷ The payment and receipt of interest forms the very essence of conventional banking actions and the functioning of western banks without interest appears to be beyond reason or imagination.⁵⁴⁸

The Quran perceives monies to be a mechanism for exchange and not a tradable product; it thus aims to safeguard the interests of the underprivileged by ensuring that they are not forced or mandated to make interest payments.⁵⁴⁹ The Quran thus expounds upon the very basic concept of inequity in the levying of interest, arguing that whilst it is acknowledged that a borrower of monies is likely to produce irregular at unpredictable revenues through the utilisation of borrowed money, he is expected to provide predetermined and enduring returns to the provider of funds.⁵⁵⁰ Islam categorically does not permit such greedy and exploitative lending, wherein the user of funds steadily becomes poorer and the provider of funds becomes progressively more affluent.⁵⁵¹

Siddiqi, stated that the prohibition of interest by Islamic law in all business activities has resulted in the creation of an absolutely unique banking process, involving the creation of different types of financial instruments and distinct ways and means for the meeting and satisfaction of business requirements of individuals.⁵⁵² It should be kept in mind that Islamic banking focuses on the provisioning of financial assistance to people and to organisations through the creation of diverse types of cooperative and collaborative activities between the

⁵⁴⁵ *Ibid*

⁵⁴⁶ Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, Vol.39 (2010): pp. 36.

⁵⁴⁷ *Ibid*

⁵⁴⁸ *Ibid*

⁵⁴⁹ Casper, M., "Sharia boards and sharia compliance in the context of European corporate governance", *Centrum fur Religion Und Moderne*, 8, 33, (2012): 15-33.

⁵⁵⁰ *Ibid*

⁵⁵¹ *Ibid*

⁵⁵² Siddiqi, M.N., "Current Financial Crisis and Islamic Economics", *Radiance Views weekly*, 38, (2009), <<http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable-Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html>>

providers and users of funds.⁵⁵³ Such collaboration is not driven by the charging or payment of interest by the borrower to the provider, which is the accepted norm in conventional banking. The essence of cooperation and partnership is equality in the sharing of profits and losses; Islamic banking organisations thus frequently take part in the losses of their clients if and when they take place; they also provide considerable concessions for repayment of principle sums.⁵⁵⁴ The following section engages in the examination of conventional and Islamic banking practices.

Hassan and Aliyu reviewed empirical studies on Islamic banking and concentrated on their main findings.⁵⁵⁵ Their research revealed that the system performed below its conventional counterpart even with the spill over impact on Islamic banks after the financial crisis.⁵⁵⁶ Much of the empirical literature that has focused on Islamic banking practices claims that the institution has moved away from the ideal PLS model to lease and sales based contracts.⁵⁵⁷ The interest rate is one of the determining factors, rather than real economic activities, which influence Islamic banking. Whilst Islamic banks have been labelled as cost inefficient, a few studies found them to be superior with regard to managerial competency and profit efficiency.⁵⁵⁸ The sustenance of management skill is essential for the long term survival of the system and the industry requires ongoing capacity development on account of frequent alterations in global financial practices.⁵⁵⁹ It was found that Islamic banks across borders operate the same brand products with different structures; some products are rebranding the conventional ones without substantial Sharia compliance.⁵⁶⁰ Whilst Sharia restrictions reduce the risky behaviour of Islamic banks, insolvency risk is influenced by the income structure of the banks as the shareholder and depositor structure of Islamic banks constitutes a higher share of industry ownership.⁵⁶¹ Islamic banks should improve their risk management strategies to maintain high degrees of solvency. It was also found that disclosure had a positive impact on the long term performance of Islamic banks in the GCC region as more than 90% of the poor population was excluded from microfinance access; Islamic banks should thus focus on rural SMEs to help those with entrepreneurial mindsets out of

⁵⁵³ *Ibid*

⁵⁵⁴ *Ibid*

⁵⁵⁵ Hassan, M., & Aliyu, S., "A contemporary survey of islamic banking literature", *Journal of Financial Stability*, 34, (2017): 12-43.

⁵⁵⁶ *Ibid*

⁵⁵⁷ *Ibid*

⁵⁵⁸ *Ibid*

⁵⁵⁹ *Ibid*

⁵⁶⁰ *Ibid*

⁵⁶¹ *Ibid*

poverty.⁵⁶² Monitoring and supervision finally needed to be intensified despite the growing performance of a dual banking system in some countries, with particular regard to the development of a competitive environment for fair price setting.⁵⁶³

Abedifar *et al* examined recent empirical literature on Islamic banking and finance.⁵⁶⁴ Their studies found that whilst earlier studies tended to focus on production technology, efficiency and general performance features of Islamic versus conventional banks, recent works tend to stress on profit sharing and loss bearing behaviour, competition risks, small business lending and financial inclusion.⁵⁶⁵ Their study found that Islamic finance assists in inclusion and the development of the financial sector.⁵⁶⁶ Studies have also revealed that Islamic funds perform as well if not better than conventional funds. The authors found that Islamic banks were as efficient as their conventional counterparts and had lower risks of default and insolvency.⁵⁶⁷ They typically focused on higher margin small business borrowers who were less likely to default.⁵⁶⁸ There is some evidence that Islamic banks can be more competitive than their conventional counterparts and the spread of Islamic banking can help in financial inclusion and economic development.⁵⁶⁹

4.1.5 **Comparison of Conventional and Islamic Banking**

It is important to keep in mind that many conventional banking instruments are similar to those in Islamic banking, but differentiation takes place on account of dissimilarities in validating processes.⁵⁷⁰ Islamic banking adheres to Sharia tenets, whereas conventional banking has evolved through practice and custom and is controlled by common law.⁵⁷¹ The specific features of conventional and Islamic banking are detailed below.⁵⁷²

Table 4: Differentiating Features of Islamic and Conventional Banks⁵⁷³

⁵⁶² *Ibid*

⁵⁶³ *Ibid*

⁵⁶⁴ Abedifar, P., Ebrahim, S.M., Molyneux, P., & Tarazi, A., “Islamic banking and finance: recent empirical literature and directions for future research”, *Journal of Economic Surveys*, 29, 4 (2015); 637–670.

⁵⁶⁵ *Ibid*

⁵⁶⁶ *Ibid*

⁵⁶⁷ *Ibid*

⁵⁶⁸ *Ibid*

⁵⁶⁹ *Ibid*

⁵⁷⁰ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., “Cost, revenue and efficiency of Islamic versus conventional banks: inter- national evidence using DEA”, *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁵⁷¹ *Ibid*

⁵⁷² *Ibid*

⁵⁷³ Hamedian, B., “*Financial Performance of Islamic Banks vs. Conventional Banks: The Case of Malaysia*”, (2013), p 9, <[i-rep.emu.edu.tr:8080/jspui/bitstream/11129/639/1/Hamedian.pdf](http://rep.emu.edu.tr:8080/jspui/bitstream/11129/639/1/Hamedian.pdf)>

Islamic Banks	Conventional Banks
The association of Islamic banks with their clients is of (a) purchasers, (b) suppliers and (c) partners.	The association of secular banks with their customers is of creditors or debtors.
The objective of Islamic banking is achievement of profits, within Shariah limitations.	The aim of secular banking is profit enhancement without religious restrictions.
The primary objective of Islamic banking is involvement in partnership with customers.	The basic activity of secular banks is taking deposits, giving money, providing and levying of interest.
The various operating policies of Islamic banks should comply with the Shariah.	Secular banking strategies and policies are shaped by managements after appropriate thinking and analysis.
Substantial importance is given by Islamic banking to public benefit.	In secular banking, the benefit of the bank is supreme. Present day banks are nonetheless introducing and adopting corporate social responsibility in their operations.
Giving and taking interest is absolutely prohibited in Islamic banking. This motivates risk sharing k between Islamic banks and customers.	Secular banks levy and provide interest at pre-arranged rates.
Islamic banks stress on project viability.	Secular banks stress on the ability of customers for repayment.
Islamic banks do not levy penalties on defaulters and give flexible concessions for before time settlement. Small amounts are however levied for delays and consequently given to charity.	Penalties are levied on defaulters
Islamic banks stress upon project assessment driven by their strategy of part taking in the profits and losses of customers.	Commercial banks place more emphasis upon collateral security and the capacity of borrowers to repay borrowings.
Guarantees by Islamic banks make use of the tenets	Secular banks have to pledge and

of Al-Wadiah, wherein depositors are sure of repayment. Customers nevertheless must participate in losses in cases of Mudharabah.	make sure repayment of deposits.
Islamic banks function as Zakat collection locations and must make payment of Zakat if their profits and wealth exceed specific amounts.	Zakat is not applicable to secular banks.
Islamic banks can borrow monies for Shariah compliant deals.	Commercial banks do not have such restrictions.
Real Assets are products, rather than money and money is thus just a medium of exchange.	Money is considered to be a product, as also a medium of exchange and the repository of value.
Profits are achieved on exchanging of goods and services.	Interests on borrowing are levied in accordance with time value.
Losses are shared between the banker and the customer.	Loss is not shared between the banker and the customer.
Money is not spent as there are goods and services at the back of money; inflation is thus not developed.	Goods and services are there behind money at the time of payment of funds; expansion of money will result in inflation.
As inflation is limited, borrower does not increase his price.	Inflation will force the borrower to increase the prices of goods and services in order to recover the cost of the product.
The existence of capital goods should be ensured before funds are paid for a capital project.	Lending of long loans is finalised on the basis of the projected feasibility of the business and the reputation of the borrower; it is not made on the basis of existence of capital goods.
The government should provide goods to the national investment fund in order to obtain funds from monetary agencies.	Governments can effortlessly get loans from central banks without any expenditure on capital development.
Elimination of expansion of money leads to a balanced budget.	Deficit financing occurs on account if absence of backing of expended

	money by real assets.
The failure of a project can result in the change of management and the implementation of a superior management structure.	The failure of a project results in the loan been considered as a non-performing asset.
Real wealth is in the hands of many people, which ensures the occurrence of real growth in the wealth of people.	Money stays with few people; therefore, real expansion of wealth does not occur.
Additional taxes are provided to the government in Mudarabah and Musharakah. This results in reduction of taxation load on salaried people. Increases occur in the savings and disposable incomes of people and consequently in enhancement of real gross domestic product.	Interest expenditure is reduced from taxable profit. As this deduction impacts saving and disposable income of individuals, the real gross domestic product experiences reduction.
Enhancement in real GDPG leads to net exports becoming strong. This leads to decrease in the amount of foreign debt and in the strengthening of local currency.	Reduction in real GDP results in net exports becoming negative. This results in increase in foreign debt and loss of value in local currency.

4.1.6 **Important Islamic Finance Products**

The prohibition of interest in Islamic finance has resulted in the formation of a range of Islamic financial products that give clients of conventional banks several attractive alternatives to existing conventional banking products and services.⁵⁷⁴

These banking products can be divided into two specific sections, i.e. (1) mark-up price agreement and (2) equity-type agreements.⁵⁷⁵ The latter work on the assumption of participation and sharing of profits, losses and risks and can be categorised into Mudarabah (trust financing) and Musharakaha (collaborative partnership agreements). With regard to Mudarabah agreements, owners of business share their earnings with suppliers of capital in accordance with pre-agreed ratios.⁵⁷⁶ These contracts are distinguished by the absence of particular yearly payments or of assurances of specific earnings and are thus separate in character from traditional types of financing, wherein borrowings are safeguarded through security and where repayments against

⁵⁷⁴ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁵⁷⁵ *Ibid*

⁵⁷⁶ *Ibid*

such borrowings are not dependent on the revenue earnings of businesses.⁵⁷⁷ In secular banking, losses are taken in by the debtors and do not impact the lenders in any ways.⁵⁷⁸ Islamic law nevertheless mandates that both providers and users of funds should participate in financial loss.⁵⁷⁹ Islamic banking institutions are required to participate in the profits and losses of their borrowers, but are not expected to engage in managerial or operation control of the businesses of borrowers, especially when they are controlled and managed by experienced professionals, managers and entrepreneurs.⁵⁸⁰

Musharaka is distinct from Mudharaba and relates to a partnership agreement between two parties, wherein both parties provide contributions towards the capital that is invested in a business activity.⁵⁸¹ Both the entities in Musharaka contracts, share in the profits and losses through predetermined agreements.⁵⁸² Losses, in these circumstances are shared in proportions that are similar to capital contributions; sharing of profits however occurs through predetermined contracts that do not have to necessarily be in accordance with the capital invested.⁵⁸³ The entities in a Musharaka agreement control and participate in the management of the financed business and the banks are authorised to manage and supervise the preparation and examination of the accounts and books of business organisations that engage in such agreement.⁵⁸⁴ The liabilities for losses in these circumstances are unlimited and the partners to a contract are bound to the various promises and commitments of their partners in financial issues.⁵⁸⁵ Islamic banks can thus enter into business projects with their clients in Musharaka, as well as Mudarabha contracts, which is not possible in conventional banking.⁵⁸⁶

Contracts for mark-up prices differ from equity type agreements and are mainly used for the funding of purchases of assets by banks, which are compensated by previously negotiated profit margins.⁵⁸⁷ With regard to Murabaha contracts, Islamic banks purchase particular assets on behalf of individuals, entrepreneurs or businesses and subsequently resell these items back to

⁵⁷⁷ *Ibid*

⁵⁷⁸ *Ibid*

⁵⁷⁹ *Ibid*

⁵⁸⁰ *Ibid*

⁵⁸¹ Malkavi, B.H., "Financial derivatives between Western legal tradition and Islamic finance: a comparative approach", *Journal of Banking Regulation*, 15, (2014): 14-55.

⁵⁸² *Ibid*

⁵⁸³ *Ibid*

⁵⁸⁴ *Ibid*

⁵⁸⁵ *Ibid*

⁵⁸⁶ *Ibid*

⁵⁸⁷ Lewis, M.K., "In what ways does Islamic banking differ from conventional finance?", *Journal of Islamic Economics, Banking and Finance*, 4, 3 (2008): 4-6.

them at predetermined prices that include profit margins.⁵⁸⁸ The payments in such agreements are made through two options, i.e. either through future instalments or through the payment of lump sum amounts in future.⁵⁸⁹ The financing banks retain ownership of assets in these agreements until the clearance of all obligations.⁵⁹⁰ It is interesting to note that these agreements are very similar to those involving trade financing; such trade financing is however based upon interest and their contractual features are also.⁵⁹¹

Ijara agreements are concerned with the funding of purchases that are required for particular purposes.⁵⁹² Islamic banks, in the case of Ijara contracts, purchase assets on behalf of individuals or organisations and subsequently allow them to utilise these assets in return for particular payments of rentals.⁵⁹³ The ownership of these assets in Ijara contracts stays with the financing banks or is progressively transferred to the users of the assets against the making of lease payments.⁵⁹⁴

Mubaraka and Ijara agreements comprise most of the transactions and dealings that are conducted by Islamic banks. These organisations nevertheless also utilise diverse other instruments like zero return benevolence borrowing, progressive payments and funding of deferred payments. Many of these Islamic finance instruments have been described in the glossary provided at the beginning of this study.

⁵⁸⁸ *Ibid*

⁵⁸⁹ *Ibid*

⁵⁹⁰ *Ibid*

⁵⁹¹ *Ibid*

⁵⁹² El-Gamal, M., *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University, Houston: USA, 2000).

⁵⁹³ *Ibid*

⁵⁹⁴ *Ibid*

5 Discussion and Analysis of Secular and Islamic Finance theory /

Products in the Context of the Financial Crisis

5.1.1 Comparative Performance of Islamic and Conventional Banks before and during the Financial and Economic Crisis

Samir Srairi undertook an exhaustive and comparative evaluation of the operations of Islamic and conventional banks from 1999 to 2007.⁵⁹⁵ He made use of statistical methods to examine operational efficiencies in areas of revenues, costs, profitability, asset usage and revenue expansion of more than 70 conventional and Islamic banks.⁵⁹⁶ The study initially evaluated stochastic cost and profit frontiers with the assistance of particular functional forms.⁵⁹⁷ He included country level variables in these frontiers in order to account of differences in banking technologies and dissimilarities in the macro environmental circumstances of different companies.⁵⁹⁸

He subsequently calculated and compared the scores for costs as well as alternative profit proficiencies of diverse countries and different types of banks.⁵⁹⁹ Banks were considered to be financial intermediaries responsible for the collection of funds and the utilisation of labour and capital to convert these finances into loans and various types of profit earning assets.⁶⁰⁰ The input prices comprised those of capital, funds and labour.⁶⁰¹ The variables of the country levels were segmented into (1) macroeconomic variables and (2) measures of banking industry structures.⁶⁰² Macro environmental variables comprised (1) GDP per capita, (2) demand density, (3) extent of monetisation, (4) average inflation rate and (5) population density.⁶⁰³ Srairi study resulted in the following conclusions;

⁵⁹⁵ Srairi, S. A., "Cost and profit efficiency of conventional and Islamic banks in GCC countries", *Journal of Productivity Analysis*, 34, 1, (2009): 45-62.

⁵⁹⁶ *Ibid*

⁵⁹⁷ *Ibid*

⁵⁹⁸ *Ibid*

⁵⁹⁹ Platt, G., "Best Emerging Market Banks 2010", *GlobalFinance*, 24, (2010): 46.

⁶⁰⁰ *Ibid*

⁶⁰¹ Srairi, S. A., "Cost and profit efficiency of conventional and Islamic banks in GCC countries", *Journal of Productivity Analysis*, 34, 1, (2009): 45-62.

⁶⁰² *Ibid*

⁶⁰³ *Ibid*

- The price coefficients of cost functions were found to be positive.
- The elasticity of labour costs exceeded the elasticity of financial costs.
- Greater generation of loans and other types of earning assets resulted in higher profits and costs.
- The banking efficiency of the GCC nations was related to high per capita GDP levels.
- The level of concentration is related to higher banking processes.
- Banking systems with greater loans to deposits, population, demand density and capital to total assets were associated with lesser costs.
- Enhancement in profit efficiency was related to GDP per capita, financial debt, extent of monetisation and capital ratios.
- Scores for cost efficiencies were lesser than scores for profit efficiencies.
- Conventional banks were found to be more efficient, with specific regard to both costs and profits, than Islamic banks between 1999 to 2007.⁶⁰⁴

Hassan and Dridi, on the other hand carried out in their study in 2010 on the comparative performance of Islamic and conventional banks in Jordan, Malaysia, Turkey and the GCC states.⁶⁰⁵ They made use of important variables for evaluation of the effect of the financial crisis; these variables included alterations in the value of bank assets, bank lending, bank profitability and external bank rating.⁶⁰⁶ Their database was developed for 90 Islamic and conventional banks; 25% of these banks were Islamic. Hasan & Dridi found that Islamic banks had significantly higher ratios for (1) capital to assets and (2) capital adequacies.⁶⁰⁷ Their investment portfolios were smaller and they tended to depend lesser on bank deposits.⁶⁰⁸ The investments of Islamic banks were found to be lesser because of their lower engagement in the toxic assets and

⁶⁰⁴ *Ibid*

⁶⁰⁵ Hasan, M., & Dridi, J., "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study", *International Monetary Fund*, IMF Working Paper, (2010), <www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf>

⁶⁰⁶ *Ibid*

⁶⁰⁷ *Ibid*

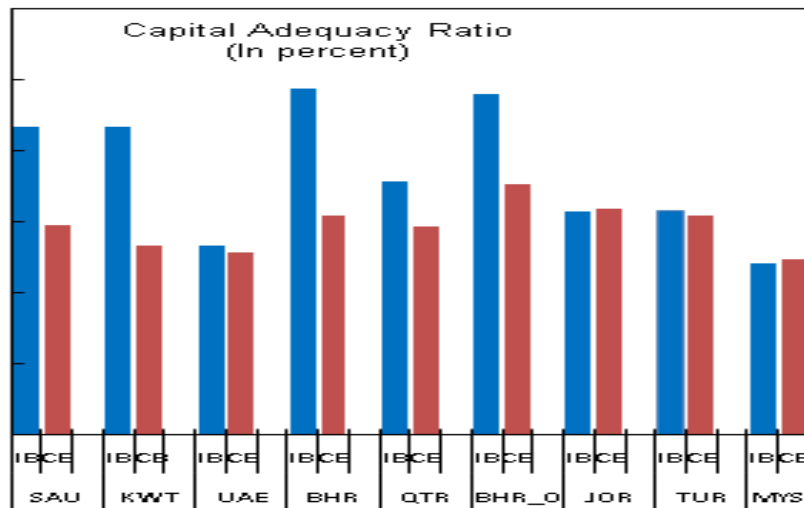
⁶⁰⁸ *Ibid*

bonds of conventional banks.⁶⁰⁹ Islamic banks did not have hedging instruments and tools, which restricted the volume of their investments.⁶¹⁰

Hasan and Dridi found that Islamic banks performed with greater profitability in 2008 in all the GCC countries with the exception of Qatar.⁶¹¹ Their profitability levels were specifically higher in Saudi Arabia and Bahrain.⁶¹² The profitability of these banks however dropped sharply in 2009 and they performance was poorer than those of conventional banks in the UAE, Qatar and Bahrain.⁶¹³ The researchers found that Islamic banks achieved greater credit growth in 2008 but lesser credit growth in 2009 than conventional banks.⁶¹⁴

The charts and tables detailed below provide relevant quantitative information on the performance of Islamic and conventional banks during 2008 and 2009.

Chart 3: Capital Adequacy Ratio⁶¹⁵



⁶⁰⁹ *Ibid*
⁶¹⁰ *Ibid*
⁶¹¹ *Ibid*
⁶¹² *Ibid*
⁶¹³ *Ibid*
⁶¹⁴ *Ibid*
⁶¹⁵ *Ibid*

Chart 4: Leverage Ratio⁶¹⁶

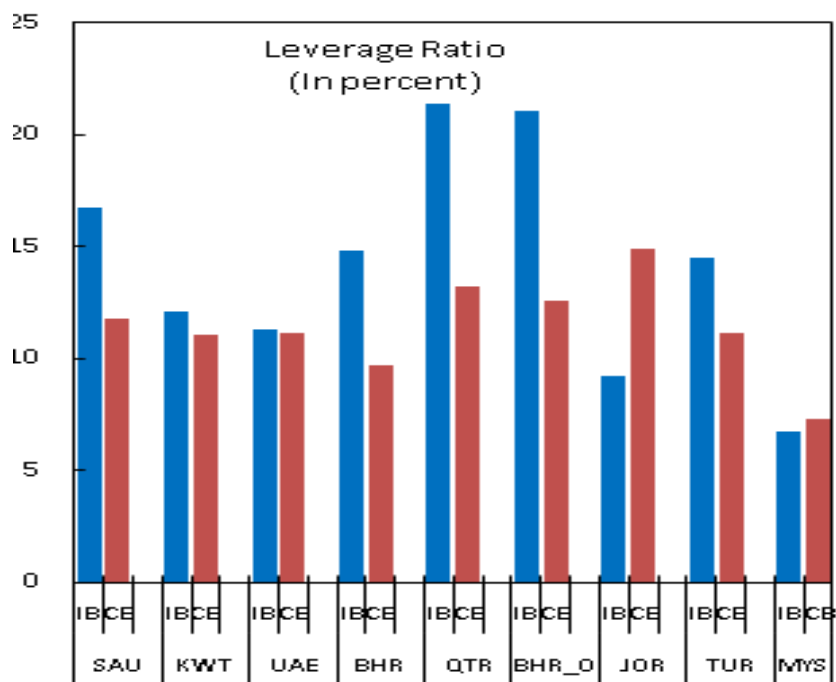
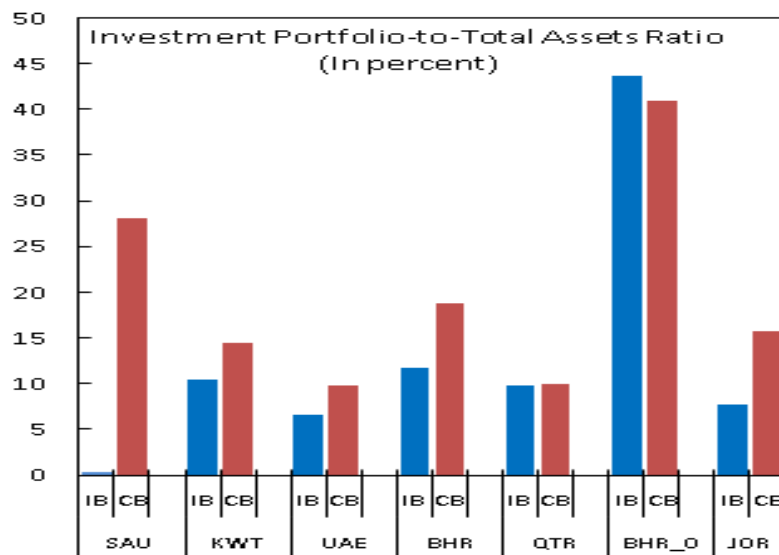


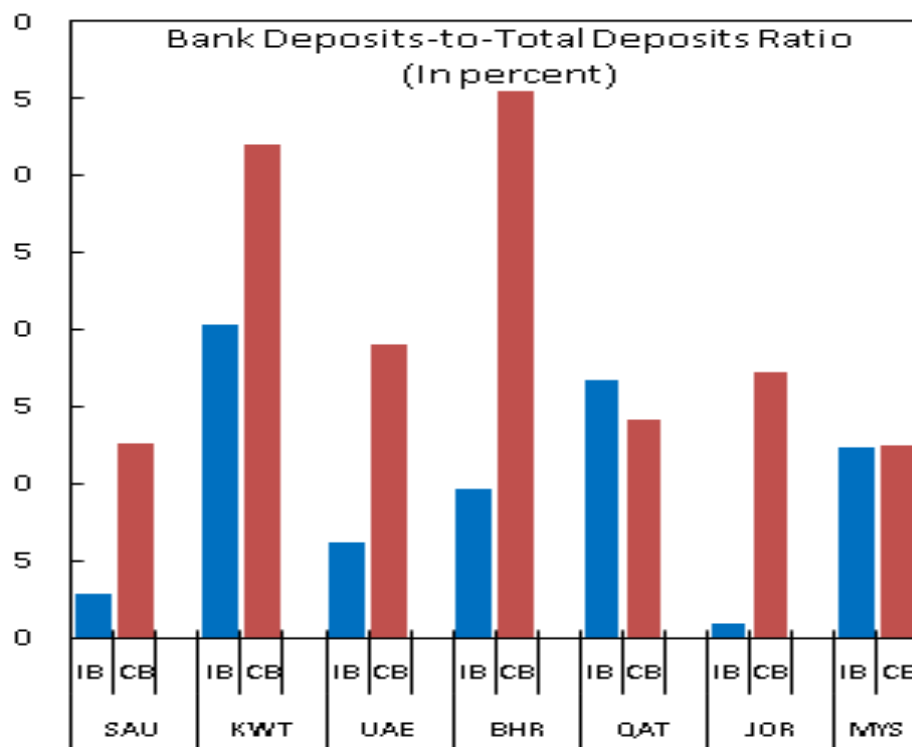
Chart 5: Investment Portfolio to total Assets Ratio⁶¹⁷



⁶¹⁶*Ibid*

⁶¹⁷*Ibid*

Chart 6: Bank Deposits-to-Total Deposits Ratio⁶¹⁸



⁶¹⁸ *Ibid*

Table 5: A Comparison between Islamic Banks and Conventional Banks Sectoral Distribution of Credit (In percent, 2008)⁶¹⁹

	Saudi Arabia		Kuwait		UAE		Bahrain		Qatar	
	IB	CB	IB	CB	IB	CB	IB	CB	IB	CB
Consumer Loans	35.1	18.9	12.0	12.8	31.0	24.2	22.8	32.0	26.0	25.0
Real Estate and Construction	5.5	8.3	18.9	15.4	26.0	18.4	12.1	19.7	38.3	19.2
Public Sector	15.5	9.8	0.0	9.0	7.1	14.5	1.3	6.8	5.9	27.5
Trade	27.0	23.6	28.5	5.4	7.8	10.0	15.7	21.6	21.4	8.1
Others	16.9	39.4	40.6	57.4	28.1	32.9	48.0	19.9	8.5	20.2

⁶¹⁹*Ibid*

Table 6: The Impact of the Crisis on Profitability, Credit Growth, Assets Growth, and Ratings for Islamic (IB) and Conventional (CB) Banks (2008–10)⁶²⁰

	Saudi Arabia		Kuwait		UAE		Qatar		Bahrain	
	IB	CB	IB	CB	IB	CB	IB	CB	IB	CB
Part 1: Change in Profitability (In percent)										
2008-2007	2.0*	-31.1	-46.5	-82.3	1.1	5.7	23.5	31.4	-15.0	-17.7
2009-2007	-0.1	-19.2	-78.3	-60.1	-42.2	-7.6	5.6**	38.4	-111.8	-27.7
Avg (2008-2009) -20070.9	0.9*	-25.2	-82.4	-71.2	-20.6	-1.0	14.6**	34.9	-63.9	-22.7
Number of banks (Max)	2.0	9.0	2.0	6.0	5.0	14.0	2.0	6.0	5.0	6.0
Number of banks (Min)	2.0	9.0	2.0	6.0	4.0	14.0	2.0	6.0	5.0	6.0
Part 2: Growth in Credit (In percent)										
2008-2007	26.9	28.0	18.0	16.3	39.5	38.1	69.0	48.2	37.1	15.7
2009-2008	9.6**	-1.8	19.8	1.5	4.3	4.6	13.5**	0.5	2.3	5.9

⁶²⁰*Ibid*

2009-2007	38.7	27.0	30.9	18.3	44.4	44.9	91.7*	16.1	47.9	22.3
Change (2009-08 and 2008-07)	- 17.3* *	-30.7	1.8	-14.8	-35.1	-35.5	-55.5	-44.6	-34.9*	-9.8
Number of banks (Max)	2.0	9.0	2.0	6.0	5.0	14.0	2.0	6.0	5.0	6.0
Number of banks (Min)	2.0	9.0	2.0	6.0	5.0	14.0	2.0	5.0	5.0	6.0
Part 3: Growth in Assets (In percent)										
2008-2007	27.9	20.8	18.0**	3.9	17.7	20.4	48.3	37.8	35.1**	5.4
2009-2008	4.1	3.6	3.6**	-3.6	5.6	7.6	20.8*	11.7	5.8	0.5
2009-2007	32.9	24.7	22.2** *	0.5	23.9	30.2	78.4*	54.3	43.6--	5.6
Change (2009-08 and 2008-07)	-23.8	-17.2	-14.4	-7.5	-12.1	-12.8	-27.4	-26.1	-29.2**	-4.9
Number of banks	2.0	9.0	2.0	6.0	5.0	14.0	2.0	6.0	5.0	6.0

(Max)										
Number of banks (Min)	2.0	9.0	2.0	6.0	4.0	14.0	2.0	5.0	5.0	6.0
Part 4: Change in Rating between pre-Lehman Brothers and April 9, 2010 (change in the probability of default; positive change = downgrading)										
Pre-Sept 08-April 9, 2010,	0	0	0	255	606*	61	0	0	0	0
Number of Banks	1.0	8.0	2.0	6.0	4.0	10.0	1.0	4.0	1.0	4.0

3.4.2. Risk Management in the Conventional and Islamic Banking System

Conventional banking operations across the world function through the taking of public deposits and the exploitation of deposit finances in safe investment alternatives through the provisioning of loan to large populations of individual and organisational customers.⁶²¹ Conventional banks help their customers, both individuals and entities by providing them with avenues for safeguarding of their money along with earning interest on their funds.⁶²²

Bank managements aim to secure and exploit their deposit funds through the careful examination and evaluation of diverse available avenues for deployment.⁶²³ Bank managements retain a specific proportion of deposits as safety reserves and invest the balance in the form of loans to diverse customers for their personal or business use.⁶²⁴ It needs to be kept in mind that banks, apart from accepting public deposits also borrow funds from other entities in order to create interest bearing loan assets.⁶²⁵ Bank managements aim to safeguard their loan through the careful assessment and evaluation of the credit worthiness repayment abilities and organisational

⁶²¹ Sinkey, F. J., *Commercial Bank Financial Management*, 6th Edition, (NJ: Prentice Hall, 2002).

⁶²² Loayza, N. V., & Ranciere, R., "Financial Development, Financial Fragility and Growth", *Journal of Money, Credit & Banking*, 38, 4, (2006): 1051.

⁶²³ Kamaruddin, B. H., Safa, M. S., & Mohammed, R., "Assessing production efficiency of Islamic banks and conventional bank Islamic windows in Malaysia", (Munich Personal RePEc, 2008).

⁶²⁴ Sinkey, F. J., *Commercial Bank Financial Management*, 6th Edition, (NJ: Prentice Hall, 2002).

⁶²⁵ *Ibid*

stabilities of their borrowers, augmented by the taking of collateral / security in various forms for liquidation in case of non-satisfaction of debt.⁶²⁶

The organisational managements of banks also try to lower banking risks through the stipulation of specific limits for their external borrowing, which in turn limits the leverage available with them for utilisation.⁶²⁷ The use of various types of safeguards notwithstanding, there is little doubt that all types of loans are associated with default risks.⁶²⁸ Defaults in payments of loans can occur on account of diverse causes, including (a) changes in borrower intent for loan servicing, (b) the organisational capacity of the borrower for cash flow management, (c) the financial performance and position of the borrower and (d) diverse environmental factors.⁶²⁹

Environmental volatility and economic difficulties can lead to diverse adverse outcomes for the larger market, the profits and cash flows of borrowers and their repayment abilities.⁶³⁰ The occurrence of natural disasters like floods, earthquakes, cyclones and Tsunamis can also impact the operations of borrowing firm and enhance the risks of lenders.⁶³¹ The operations of commercial banks are exposed to various sorts of environmental and market risks.⁶³²

The occurrence of the banking and financial debacle and the resulting international economic depression, the impact of which is still evident, have led to a greater understanding and appreciation of the various systemic risks that are prevalent in the operations of the conventional bank.⁶³³ As explained earlier the banking and financial crisis of 2008 was essentially triggered by defaults amongst US subprime borrowers and its impact on all associated banks, financial institutions and financial frameworks.⁶³⁴ The subprime crisis was driven by wrong and opportunistic corporate governance in US banks, greed for performance bonuses amongst US bankers and an unhealthy desire to generate unsustainably high profits for their organisation.⁶³⁵

⁶²⁶ Beckett, A., Hower, P., Howcroft, B., "An exposition of consumer behaviour in the financial services industry", *International Journal of Bank Marketing*, 18, 1, (2000): 15-26.

⁶²⁷ Kolari, W. J., & Gup, B. E., *Commercial Banking: The Management of Risk*, 3rd edition, (NY: Wiley, 2004).

⁶²⁸ *Ibid*

⁶²⁹ *Ibid*

⁶³⁰ Alexander, K., Dhumale, R., & Eatwell, J., *Global Governance of Financial Systems: The International Regulation of Systemic Risk*, (New York: Oxford University Press, 2006).

⁶³¹ *Ibid*

⁶³² Kolari, W. J., & Gup, B. E., *Commercial Banking: The Management of Risk*, 3rd edition, (NY: Wiley, 2004).

⁶³³ Zaring, D., "International Institutional Performance in Crisis", *Chicago Journal of International Law*, 10, 2, (2010): 475.

⁶³⁴ Moussawi, C. E., & Obeid, H., "Evaluating the Productive Efficiency of Islamic Banking in GCC: a Non-parametric Approach", *International Management Review*, 7, 1, (2011): 10.

⁶³⁵ Zaring, D., "International Institutional Performance in Crisis", *Chicago Journal of International Law*, 10, 2, (2010): 475.

Such motivation for augmentation of banking profitability led to uncontrolled lending to people who very evidently lacked the wherewithal for loan servicing and repayment.⁶³⁶ American bankers, convinced that their excessive lending would be safeguarded by inflation across the housing sector, purposely increase their borrowing (for obtaining funds for housing loans) with the help of recently developed financial tools in the form of MBS, SPVs, credit derivatives and securitisation.⁶³⁷ The application of these tools helped American banks to cluster their loans together, segregate them into saleable lots and market them to investors with dissimilar risk profiles.⁶³⁸ The use of these techniques helped bank managements to increase their borrowing capacities, lower their balance sheet risk elements, expand their cash flows, augment their mortgage activities and improve their profitability; their application however also resulted in the simultaneous spread of subprime lending risks across the banking system.⁶³⁹

The meltdown in the US subprime mortgage sector between October and December 2006 led to thousands of foreclosures of home mortgages as also in the bankruptcy and collapse of numerous providers of subprime loans.⁶⁴⁰ It is important to note that these subprime loans had been clustered into MBS and sold to diverse types of investors.⁶⁴¹ The defaults in subprime loans resulted in swift and considerable erosion in the market values of these MBS and to substantial losses for their holders.⁶⁴²

The consequent concern and panic in the market resulted in swift and sharp reduction of lending activities, the practically complete blockage of credit and the onset of the economic downturn.⁶⁴³ The generation of the financial crisis and the economic downturn along with consequent research and enquiry resulted in growing awareness and appreciation of the extensive systemic risks that have entered and entrenched themselves in the conventional banking

⁶³⁶ Shiller, R., *The subprime solution: how today's global financial crisis happened, and what to do about it*, (Princeton: Princeton University Press, 2008).

⁶³⁷ Kroszner, R., Luc, L., & Klingebiel, D., "Banking Crises, Financial Dependence, and Growth," *Journal of Financial Economics*, 84, (2007): 187–228.

⁶³⁸ Shiller, R., *The subprime solution: how today's global financial crisis happened, and what to do about it*, (Princeton: Princeton University Press, 2008).

⁶³⁹ Khan, M. M., & Bhatti, M. I., "Development in Islamic banking: a financial risk-allocation approach", *The Journal of Risk Finance*, 9, 1, (2008): 40-51.

⁶⁴⁰ Hoq, M. Z., Sultana, N., & Amin, M., "The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector", *South Asian Journal of Management*, 17, 1, (2010): 70.

⁶⁴¹ Gupta, A., "Financial crisis enforcing global banking reforms", *Business Strategy Series*, 11, 5, (2010): 286-294.

⁶⁴² Askari, H., Iqbal, Z., Mirakhor, A., & Krichene, N., *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (John Wiley & Sons (Asia) P. Ltd. Singapore, 2010).

⁶⁴³ Ariss, R., "Competitive Conditions in Islamic and Conventional Banking: A Global Perspective", *Review of Financial Economics*, (2010): 101-108.

framework.⁶⁴⁴ Conventional banks as described earlier intermediate between depositors and borrowers of banks.⁶⁴⁵ The deposits accepted by banks are merged together and distributed through various types of loans to large borrower population, thereby interconnecting millions of depositors and borrowers with the assistance of intricate and sophisticated operating.⁶⁴⁶ Banking systems are fundamentally based upon the confidence of millions of people for banks; the erosion and degeneration of such confidence can lead to significant risks and hazards for these establishments.⁶⁴⁷

Research in the aftermath of the banking and financial debacle informed that the generation of counterparty risk, i.e. the probability of banks not being able to satisfy their contractual liabilities constituted the most important of financial risks.⁶⁴⁸ The development of such risks is considered to be an outcome of asymmetric information, namely the possession of greater knowledge by financial entities about their finances than the individuals and entities who deal with them.⁶⁴⁹ Such asymmetry of information increases exponentially with the complexity of financial contracts and becomes extremely severe for investment firms and institutions.⁶⁵⁰ It also expands rapidly with greater intricacy of financial contracts and results in considerable lack of transparency for investment firms.⁶⁵¹

Some investment firms function with banks and themselves through different paths like over the counter instruments, interbank markets and prevalent systems for payments and settlements; information asymmetry in this network can clearly result in the development of large and unknown risks.⁶⁵² Settlement risks are known to emerge when one of the parties to a financial contract does not have the ability to satisfy his liabilities even after the other party has delivered.⁶⁵³ The likelihood of such defaults has grown and become a matter of considerable

⁶⁴⁴ Poole, W., "Causes and Consequences of the Financial Crisis of 2007-2009", *Harvard Journal of Law & Public Policy*, 33, 2, (2010): 421.

⁶⁴⁵ *Ibid*

⁶⁴⁶ Askari, H., Iqbal, Z., Mirakhor, A., & Krichene, N., *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (John Wiley & Sons (Asia) P. Ltd. Singapore, 2010).

⁶⁴⁷ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁶⁴⁸ Zaring, D., 2010, "International Institutional Performance in Crisis", *Chicago Journal of International Law*, Vol.10, Iss (2): pp. 475.

⁶⁴⁹ *Ibid*

⁶⁵⁰ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁶⁵¹ *Ibid*

⁶⁵² Luc, L., & Fabian, V., "Systemic Banking Crises: A New Database," (IMF Working Paper No. 08/224, 2008).

⁶⁵³ *Ibid*

worry for larger banks who engage in millions of such deals on a regular basis.⁶⁵⁴ The concurrent occurrence of numerous transactions and the complex banking system makes it extremely difficult to oversee the actions of counterparties and counterparties of counterparties.⁶⁵⁵ The risks that have entered into the conventional banking system have truly become immense and challenging.⁶⁵⁶

Islamic banking has a number of unique characteristics that differentiate it from normal banking.⁶⁵⁷ One of the most important of these differences stems from the prohibition on charging and receiving of interest.⁶⁵⁸ Such a ban on interest will obviously make it challenging for Islamic banks to work with customers who require little else than borrowing with security for purposes of trade and commerce.⁶⁵⁹ Researcher aver that such significant limitations on conventional money lending operations will primarily lead to the growth and expansion of the operations of these banks and financial institution through the development of diverse types of participative agreements between the providers and users of funds.⁶⁶⁰ Such participative working will lead to the expansion of equity, instead of the borrowing of the firms that aim to use funds.⁶⁶¹

There is little doubt that enhancement in equity at the cost of debt leads to greater business stability and safety from financial risks and vulnerability.⁶⁶² Modern financial experts argue that the utilisation of lower debt levels is bound to lead to lower profitability because of underutilisation of the tax shield that is available for interest payments; most businesses nevertheless operate with lower levels of debt if they can do so.⁶⁶³ Lower levels of debt and consequently lower repayment commitments help organisational managements to operate with lesser worries, engage in carefully calculated risks and implement their strategies without the

⁶⁵⁴ Gupta, A., "Financial crisis enforcing global banking reforms", *Business Strategy Series*, 11, 5, (2010): 286-294.

⁶⁵⁵ Ritholtz, B., *Bailout Nation: How Greed and Easy Money Corrupted Wall Street and Shook the World Economy*, (NY: Wiley, 2009).

⁶⁵⁶ *Ibid*

⁶⁵⁷ Siddiqi, M.N., "Current Financial Crisis and Islamic Economics", *Radiance Views weekly*, 38, (2009),

<[http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html](http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable%20Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html)>

⁶⁵⁸ Askari, H., Iqbal, Z., & Krichenne, N., *The stability of Islamic finance*, Oxford: Oxford University Press (2011).

⁶⁵⁹ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁶⁶⁰ Kroszner, R., Luc, L., & Klingebiel, D., "Banking Crises, Financial Dependence, and Growth," *Journal of Financial Economics*, 84, (2007): 187-228.

⁶⁶¹ *Ibid*

⁶⁶² Kamaruddin, B. H., Safa, M. S., & Mohammed, R., "Assessing production efficiency of Islamic banks and conventional bank Islamic windows in Malaysia", (Munich Personal RePEc, 2008).

⁶⁶³ *Ibid*

worry of answering and explaining to lenders.⁶⁶⁴ Research has also revealed that lower levels of debt frequently leads to higher levels of profitability and better servicing of shareholders through higher dividends and greater market values of shares.⁶⁶⁵

Islamic finance experts make the point that substitution of debt with different types of funding participation leads to substantially higher operational productivity and assists the users of finances to repay fund providers.⁶⁶⁶ One significant outcome of the prohibition of interest and the consequent development of participative agreements between banks and fund users have been the generation of close and intimate relationships between banks and clients.⁶⁶⁷ The managements of Islamic banks are aware that the safety and security of finances are fundamentally dependent upon the organisational profitability of their clients; such awareness forces the managers of Islamic banks to carefully study and evaluate the applications of their clients and their requirement for funds, along with their project details, with high levels of perspicacity and concentration; they try their best to evaluate the prospective client's business potential, viability and profitability.⁶⁶⁸ It is important to appreciate that participatory agreements are of different types and the fund provider has the option for participating in or staying away from the business.⁶⁶⁹ It is however nevertheless true that the bond between fund providers and fund users is much stronger in Islamic banking than it in conventional banking.⁶⁷⁰

Banking relationships between banks and clients in the area of conventional banking is essentially maintained at arm's length and borrowers do not welcome or appreciate high levels of bank oversight and interference in their functioning.⁶⁷¹ The association between banks and customers are essentially clinical and decided by contractual terms.⁶⁷² Such maintenance of arm's length ensures that borrowers can operate independently but at the same time enhances the chances of information asymmetry and the development of distant relationships between lenders

⁶⁶⁴ Hoq, M. Z., Sultana, N., & Amin, M., "The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector", *South Asian Journal of Management*, 17, 1, (2010): 70.

⁶⁶⁵ *Ibid*

⁶⁶⁶ Khan, M. M., & Bhatti, M. I., "Development in Islamic banking: a financial risk-allocation approach", *The Journal of Risk Finance*, 9, 1, (2008): 40-51.

⁶⁶⁷ Askari, H., Iqbal, Z., Mirakhor, A., & Krichene, N., *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (John Wiley & Sons (Asia) P. Ltd. Singapore, 2010).

⁶⁶⁸ *Ibid*

⁶⁶⁹ Loayza, N. V., & Ranciere, R., "Financial Development, Financial Fragility and Growth", *Journal of Money, Credit & Banking*, 38, 4, (2006): 1051.

⁶⁷⁰ *Ibid*

⁶⁷¹ Siddiqi, M.N., "Current Financial Crisis and Islamic Economics", *Radiance Views weekly*, 38, (2009),

<[http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html](http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable%20Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html)>

⁶⁷² *Ibid*

and borrowers.⁶⁷³ This results in conventional banks frequently being deprived of various types of information that could improve their knowledge and information of the operations and profitability of their clients.⁶⁷⁴ Conventional banks thus have to basically rely upon the annual reports of their customers in order to evaluate their performance and the security of their loans.⁶⁷⁵

Islamic banking prohibits debt that carries interest but at the same time appreciates that businesses are likely to need external funds.⁶⁷⁶ Islam contains numerous references to the advantages of businesses that are operated with honesty and provides extensive encouragement to businessmen to work hard and achieve honest profits.⁶⁷⁷

It can be surmised from the preceding discussion that the risk management methods, systems and approaches adopted by conventional banks differ extensively from Islamic banks. Conventional banks engage in detailed scrutiny of the borrower's circumstances, determine whether the borrower will be able to repay the amount taken as loan, maintain an arms-length distance with the borrowing firm and ask for periodic information as well as repayment of principal and interest.⁶⁷⁸ They also insist upon the provisioning of valuable collateral, which can be enhanced in times of default.⁶⁷⁹ The risk management system is simple and linear and can be applied across large borrower populations; it however suffers extensively from information asymmetry because the bank is unlikely to have comprehensive knowledge about the operations of the borrower and has to depend upon reports from the borrowing organisation to find out about the operations of the company and its continued ability to satisfy debt obligations.⁶⁸⁰ Borrowers often do not provide adequate information to the lending bank and bankers find out about things having gone wrong only after defaults start taking place.⁶⁸¹ The collateral in many

⁶⁷³ Hair, J.F., Sarstedt, M., Hopkins, L., & Kuppelwieser, V.G., "Partial least squares structural equation modeling (PLS-SEM): An emerging tool in business research", *European Business Review*, 26, 2, (2014): 106- 121.

⁶⁷⁴ Beltratti, A., & Stulz, R.M., "The credit crisis around the globe: Why did some banks perform better?", *Journal of Financial Economics*, 105, 1, (2012): 1-17.

⁶⁷⁵ Siddiqi, M. A., "Banking on Sharia Principles: Islamic Banking Has Witnessed Remarkable Growth from Its Humble Beginnings in the Early 1970s into a 21st Century Multi-Billion Dollar Global Niche Industry", *The Middle East*, 24, (2002): 1-5.

⁶⁷⁶ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

⁶⁷⁷ Allen, L., Bali, T.G, & Tang, Y., "Does systemic risk in the financial sector predict future economic downturns?", *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

⁶⁷⁸ Hasan, M., & Dridi, J., "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study", *International Monetary Fund*, IMF Working Paper, (2010), <www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf>

⁶⁷⁹ *Ibid*

⁶⁸⁰ *Ibid*

⁶⁸¹ Kamaruddin, B. H., Safa, M. S., & Mohammed, R., "Assessing production efficiency of Islamic banks and conventional bank Islamic windows in Malaysia", (Munich Personal RePEc, 2008).

cases proves to be inadequate or is tied up in litigation in order to prevent its immediate sale for set of against loans.⁶⁸²

The risk management system in Islamic banks is however extremely different and stems from the concept of partnership between the banker and the client.⁶⁸³ The development of such a partnership brings banking officials in much closer contact with the users of funds, right from the days of project inception to its commercial operations.⁶⁸⁴ Such an arrangement minimises and even eliminates information asymmetry because of the close involvement of the banker in the operations of the client.⁶⁸⁵ The possibility of business difficulties thus becomes obvious much earlier than it does for commercial loan transactions and facilitates preventative action.⁶⁸⁶ Bank managers are also always in a position to eliminate diversion of funds to other projects by borrowers, which, by itself is a very serious problem in commercial lending transactions.⁶⁸⁷

Iqbal stated that whilst the risk management systems of Islamic banks is undoubtedly more comprehensive and proactive than in commercial banks, it is dependent upon high levels of personal interaction between bankers and borrowers and is thus difficult to scale up extensively.⁶⁸⁸ Such a risk management system thus does not facilitate swift and effective banking growth and restricts banking profitability.⁶⁸⁹ Whilst conventional banks do have some lacunae, with particular regard to information asymmetry, in their risk management systems, their systems and methods facilitates banking growth and expansion.⁶⁹⁰ It can thus be seen that whilst Islamic bank suffer lesser losses during periods of economic depression, commercial banks earn substantially more revenues and profits when the economy improves. This in turn gives them a natural resilience to face economic difficulties and losses.⁶⁹¹

⁶⁸² *Ibid*

⁶⁸³ Kahf, M., “*Strategic Trends in the Islamic Banking and Finance movement: The Harvard forum on Islamic Finance and Banking*,” (Harvard University: Boston, 2002).

⁶⁸⁴ *Ibid*

⁶⁸⁵ *Ibid*

⁶⁸⁶ Junius, A., “Islamic finance: issues surrounding Islamic law as a choice of law under German conflict of laws principles”, *Chicago Journal of international Law*, (2007): 537- 543.

⁶⁸⁷ *Ibid*

⁶⁸⁸ Iqbal, Z., & Mirakhor, A., *An introduction to Islamic finance theory and practice*, (Singapore: Wiley, 2007).

⁶⁸⁹ *Ibid*

⁶⁹⁰ *Ibid*

⁶⁹¹ *Ibid*

5.2 Conclusions

This review of literature has been carried out with the help of diverse information sources on important aspects of the subject matter in order to develop a comprehensive and thorough understanding of the subject from diverse perspectives. The review firstly informed that Islamic banking and finance has grown progressively from rather elementary retail banking to a complex and reasonably comprehensive banking facility with a wide range of Islamic products and services.⁶⁹² With the Islamic community firstly being spread across the world and secondly being seriously interested in the pursuit of an adherence to religious norms and standards in various aspects of their lives, Islamic banking has been adopted in substantial measure by Muslims in the Islamic countries as also in the developed countries of Europe and North America.⁶⁹³ Adherence to Sharia is the dominating paradigm of Islamic banking and financial services.⁶⁹⁴ Whilst this was not difficult in the initial and elementary stages of the growth of Islamic banking, it has progressively become a rather complex and even contentious aspect of the activity.⁶⁹⁵ The growth of Islamic finance has very naturally resulted in the development of number of complex financial models, products and services, which have to be shaped, moderated and used by individual Islamic banks for their customers.⁶⁹⁶

The available literature on the subject informs that obtaining the Sharia compliance to these various new Islamic products is proving to be difficult because of (1) the complexity of the products and (2) disagreement between Sharia experts on their compliance with Islamic law.⁶⁹⁷ With there being an noticeable absence of standardisation in Islamic banking, individual banks often find it extremely difficult to assess whether their banking products are truly Sharia compliant or shall have to be moderated and modified in future with attendant inconvenience for the bank and for banking customers.⁶⁹⁸ There appeared to be general agreement on the need for

⁶⁹² Archer, S., & Abdelkarim, R., *Islamic finance: The regulatory challenge*, (Singapore: Wiley, 2007).

⁶⁹³ Aris, N.A., Othman, R., Azli, R.M., Sahri, M., Razak, D.A., & Rahman, Z.A., "Islamic banking products: regulations, issues and challenges", *The Journal of Applied Business Research*, 29, 4, (2013): 7-19.

⁶⁹⁴ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

⁶⁹⁵ Al Bashir, M., *Risk management in Islamic finance*, (London: Routledge Publishers, 2008).

⁶⁹⁶ Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A., "Islamic finance in the UK: regulation and challenges", (2007), <<http://media4.efinancialnews.com/share/media/downloads/2007/11/2349281881.pdf>>

⁶⁹⁷ Aggarwal, R. K., & Yousef, T., (2000), "Islamic Banks and Investment Financing", *Journal of Money, Banking, and Credit*, 32, 1, (2000): pp. 93-120.

⁶⁹⁸ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

bringing about greater standardisation amongst different banks, especially on the use of complex financial products, including mortgages.⁶⁹⁹

The problem of standardisation has been complicated by the fact that Sharia scholars, who are responsible for the formulation of Sharia rules for Islamic finance products are not available with all Islamic banks, which are thus often unable to decide upon the legal validity of their products.⁷⁰⁰ Some Sharia scholars have in fact stated that the very process of standardisation may oppose the basic premises of Ijtihad, a century's old process of narrowing and reducing Sharia rules from their genuine forces.⁷⁰¹ With Ijtihad driving the flexibility and dynamism of Sharia, its obsolescence on account of standardisation could result in significant differences of opinion between Sharia scholars and advocates of standardisation.⁷⁰²

The various challenges facing standardisation notwithstanding, there was wide agreement that its implementation could result in specific benefits, with particular regard to enhancement of public reputation and image, elimination of Sharia associated risks, reduction of costs and legal difficulties, enhancement of cooperation between Islamic banks and the furtherance of universality in Islamic banks.⁷⁰³ Substantial efforts were being made by diverse Islamic bodies to investigate the practicality and possibility of standardisation but consensus on the best way of doing so was yet to be developed.⁷⁰⁴

The examination of information sources on the financial crisis revealed that the disaster essentially occurred on account of overheating of the US economy on account of extensive infusion of funds in the American banking system, a sustained low interest regime, poor corporate governance in the American banking industry, enormously risky lending to home buyers who did not have the resources to repay their loans and the use of novel financial instruments like securitisation, mortgage backed securities, credit derivatives, special purpose vehicles and off-balance sheet transactions.⁷⁰⁵ Whilst these factors resulted in enhancement of financial risks for individual banks and the spread of systemic risk through the western banking

⁶⁹⁹ Askari, H., Iqbal, Z., & Krichenne, N., *The stability of Islamic finance*, Oxford: Oxford University Press (2011).

⁷⁰⁰ Ausaf, A., "Islamic Banking in the Informal Sector: Interest-free Solutions in Non-Muslim Societies", *Review of Islamic Economics*, 14 (2003): 67-92.

⁷⁰¹ Balz, K., "Sharia risk? How Islamic finance has transformed Islamic contract law", (2008), <www.law.harvard.edu/programs/ilsp/publications/balz.pdf>

⁷⁰² Bianchi, R. R., "The Revolution in Islamic Finance", *Chicago Journal of International Law*, Vol. 7, 2, (2007): 569-581.

⁷⁰³ Boesch, R., *Banking Regulation*, (The European Lawyer: UK, 2012).

⁷⁰⁴ Booth, A., Papaioannou, D., & Sutton, A., *Systematic approaches to a successful literature review*, (Cambridge: Cambridge University Press, 2012).

⁷⁰⁵ Brunnermeier, M.K., "Liquidity Credit Crunch", (2009),

<http://www.princeton.edu/~markus/research/papers/liquidity_credit_crunch.pdf>

industry, these developments were compounded by poor regulatory activity and inadequacies on the part of accounting firms and credit rating authorities.⁷⁰⁶ The failures of numerous subprime borrowers to repay their loans resulted in the generation of the subprime crisis and to very substantial losses across the interconnected western banking system.⁷⁰⁷ The collapse of Lehman Brothers and numerous other large banks resulted in panic across the financial system, a sustained credit squeeze and a global economic downturn.⁷⁰⁸

It is of interest to note that the Islamic banking sector was by and large unaffected by the banking crisis, primarily because of their adherence to Islamic law, which prohibited speculative activity of any kind and thus prevented from making use of securitisation, mortgage backed securities, credit derivatives and other financial instruments that contributed to the acceleration of the crisis in the western banking sector.⁷⁰⁹ Whilst Islamic banks fared far better than conventional banks in 2008, most conventional banks caught up with their Islamic counterparts in 2009 after overcoming the adversities of the financial crisis.⁷¹⁰ There is wide agreement on the fact that Islamic banks possibly have good risk management systems on account of the fact that bankers enter into partnerships with clients for the furtherance of financing transactions.⁷¹¹ This results in significantly greater interaction between bankers and clients, elimination of information asymmetry, earlier diagnosis of difficulties and swifter corrective action.⁷¹²

The review of literature furthermore revealed that Islamic banking is being perceived with great interest and seriousness by western governments, especially in Western Europe and the UK, which are home to large numbers of Muslims who would possibly prefer to patronise Islamic banks if their financing needs can be adequately satisfied.⁷¹³ The UK has in fact brought about legal and regulatory changes to develop a non-discriminatory regime and streamline the working of Islamic banks within the overall ambit of common law.⁷¹⁴ Certain difficulties

⁷⁰⁶ Calomiris, C., & Haber, S., *Fragile by Design: Banking Crises, Scarce Credit, and Political Bargains*, (Princeton: Princeton University Press, 2014).

⁷⁰⁷ Calluzzo, P., & Dong, G.N., "Has the financial system become safer after the crisis? The changing nature of financial institution risk", *Journal of Banking and Finance*, 53, (2015): 233-248.

⁷⁰⁸ Chernoff, A., "Lehman Brothers a victim of US subprime crisis", *IBN Live*, (2008), <ibnlive.in.com > Business>

⁷⁰⁹ Moore, E., *The International Handbook of Islamic Banking and Finance*, (Cranbrook: Global Professional Publishing, 2009).

⁷¹⁰ Schoon, N., *Islamic banking and finance*, (London: Spiramus press Ltd, 2009).

⁷¹¹ Siddiqi, M.N., "Current Financial Crisis and Islamic Economics", *Radiance Views weekly*, 38, (2009), <<http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable-Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html>>

⁷¹² Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁷¹³ Venardos, A. M., *Islamic Banking and Finance in South-East Asia: Its Developments and Future World*, (USA: Scientific Publishing Co Pte Ltd, 2006).

⁷¹⁴ Usmani, M.T., *An introduction to Islamic finance*, (London: Brill Publishers, 2012).

however exist in the regulation of Islamic financial institutions, with particular regard to Sharia compliance.⁷¹⁵ The Murabaha mortgage for example is structurally different from the mortgages provided by commercial banks in the UK; differences in the structuring of financial instruments results at times in confusion over their actual implementation and utilisation by Islamic banks in the UK.⁷¹⁶

It is also practically not possible to expect the FSA to adopt approaches that are similar to those of Sharia boards or Sharia experts with regard to financial instruments including mortgages.⁷¹⁷ With the FSA's approach being secular and that of the Sharia boards essentially Islamic, any similarity in approach is essentially coincident.⁷¹⁸ It is not possible for the FSA to differentiate between diverse interpretations of Islamic law and provide their customers with assurances regarding the Sharia compliance of their product.⁷¹⁹ The FSA for example wants the directors of banks to provide proof of their suitability for directorial responsibilities by asking them to sit for a test on banking. This might be highly objectionable to Sharia experts, who have strong knowledge of the law, even though it is Islamic in nature. It is important to keep in mind that Malaysia, as well as a few other countries have reserved this issue by the establishment of a central Sharia committee whose sole responsibility is to bring individual clients and the bank together.

The review of literature reveals that whilst the provisioning of Islamic financial mortgages is increasing significantly, especially in the Middle East and other Islamic countries. Its performance has not been the same in western countries, even in areas with enhanced Muslim populations.⁷²⁰ Much of this apparent reluctance to adopt Islamic finance as a way of life is being obstructed by one particular problem.⁷²¹ Lack of standardisation of Muslim practices, both in the workplace and outside.⁷²² Such lack of standardisation is resulting in inconsistency in the approach of Islamic banks towards a specific issue, the obligations of Islamic bank managers

⁷¹⁵ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁷¹⁶ Ahmed, A.M., & Ghuddah, A.S.A., "Sharia Opinions (Fatwa) On Murabaha", <<http://www.albaraka.com/media/pdf/Research-Studies/RSMR-200706201-EN.pdf>>

⁷¹⁷ Financial Services Authority, "Principles of good regulation", (2014), <<http://www.fsa.gov.uk/Pages/about/aims/principles/index.shtml>>

⁷¹⁸ *Ibid*

⁷¹⁹ *Ibid*

⁷²⁰ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

⁷²¹ *Ibid*

⁷²² Dubai Media Incorporated, "Islamic finance needs global standardisation of regulations", (2013), <<http://www.emirates247.com/business/economy-finance/islamic-finance-needs-global-standardisation-of-regulations-2013-07-31-1.516228>>

towards their customers under mortgage contracts and different lending practices by different banks.⁷²³ With the average Muslim person in western society having the flexibility to work with an extremely standardised western banking system, which furthermore provides numerous financing options and choices, it is likely to be very difficult for Islamic banks to increase their business in non-Islamic states.⁷²⁴ This absence of standardisation and its consequences, both for customers and for bankers, forms the information gap for this project and has been taken up for detailed study in this dissertation.

⁷²³ *Ibid*

⁷²⁴ *Ibid*

Chapter 4: Ancient Law of Mortgages and Modern Law of Securitisation

6.1 Introduction

A mortgage essentially constitutes a legal agreement, which a bank, a financial institution, a building society or any other financier uses in order to lend money at interest in exchange for taking title of the debtors property with the attached condition that the conveyance of the title to the property becomes void upon payment of the debt.⁷²⁵ Adam and Schuermann stated that a mortgage was essentially a debt instrument that was secured by the collateral of clearly specified real estate property, which the borrower was under obligation to repay with a predetermined set of specific payments.⁷²⁶ Mortgages are used by individuals and other entities to purchase real estate without paying the complete value of the purchase in the beginning.⁷²⁷ The borrower repays the loan as well as interest until and unless he owns a property, free of any encumbrances.⁷²⁸ It is important to appreciate that default in repayment of mortgage obligation can result in foreclosure of mortgage and in the seizure of the property.⁷²⁹

A home buyer, in a residential mortgage essentially pledges his or her home to the financing institution.⁷³⁰ The financing institution, in such case is entitled to a claim on the house in the case of default on payment of mortgage.⁷³¹ The bank may, in the case of foreclosure evicts the tenants of the home and sell the house, using the income from the sale to clear the mortgage outstanding debt.⁷³² It is of considerable interest to keep in mind the mortgages form one of the most important areas of business for commercial banks.⁷³³ The subprime crisis in the USA actually took place because US banks disbursed mortgage loans to thousands of buyers who did not have the capacity to repay their mortgage loans.⁷³⁴ Islamic banks also recognise the

⁷²⁵ Lang, W. W., & Jagtiani, J. A., "The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance", *Atlantic Economic Journal*, 38, (2010): 295-316.

⁷²⁶ Adam, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

⁷²⁷ *Ibid*

⁷²⁸ Ghent, A.C., & Kudlyak, M., "Recourse and Residential Mortgage Default: Evidence from U.S. States", *Review of Financial Studies*, 24, 9, (2011): 3149-3186.

⁷²⁹ *Ibid*

⁷³⁰ Ashcraft, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Foundations and Trends in Finance*, 2, (2008): 191-309.

⁷³¹ *Ibid*

⁷³² *Ibid*

⁷³³ Ariss, R., "Competitive Conditions in Islamic and Conventional Banking: A Global Perspective", *Review of Financial Economics*, (2010): 101-108.

⁷³⁴ *Ibid*

importance of individual and entities to purchase real estate, both for residential and commercial purposes and have thus developed specific financial instruments for mortgages, which are known as Murabaha.⁷³⁵ This section provides information on various aspects of mortgage law in order to develop a theoretical background for the conduct of subsequent case study research.

6.2 Relevant Laws and Regulations

6.2.1 Ancient Origins of Mortgage Law

With housing becoming increasingly expensive over the years, only a small proportion of the contemporary middle class can afford to buy homes without applying for mortgages.⁷³⁶ The market for mortgages has also evolved with the ever changing face of real estate.⁷³⁷ The history of mortgages across the world is characterised with booms and busts that have helped and harmed people.⁷³⁸ Mortgages nevertheless continue to be the primary and most important form of lending, with regard to property transactions.⁷³⁹ The process of mortgaging entails the provisioning of monies to a person to obtain a home on the assumption that the debtor will repay the loan, along with interest.⁷⁴⁰ Both the debtor and lender are likely to benefit from mortgages if nothing goes wrong.⁷⁴¹

Mortgages can be traced back to ancient civilisations.⁷⁴² Several experts have hypothesised that debtors essentially swore pledges to obtain home properties before the advent of the mortgage as it is known now.⁷⁴³ The lender would engage in an agreement with a borrower to exchange property in return for repayment over time.⁷⁴⁴ Such pledge would become dead when the borrowing party could or could not meet the requirements of the agreement.⁷⁴⁵ One of the earliest narratives of mortgage law has come from ancient India; the Code of Manu, a famous

⁷³⁵ Askari, H., Iqbal, Z., & Krichenne, N., *The stability of Islamic finance*, Oxford: Oxford University Press (2011).

⁷³⁶ Guidotti, A.P., "Mortgages and Trust Deeds: Enforcement of a Secured Debt in California", *California Law Review*, 31, 4, (1943): 429–35.

⁷³⁷ Helderman, L.C., *National and state banks: a study of their origins*, (London: Google ebook, 1980).

⁷³⁸ Lee, A. J., "Farm Foreclosures in the United States during the Interwar Period", *Journal of Economic History*, 43, 4, (1983): 885–903.

⁷³⁹ Glaeser, E., & Scheinkman, J., "Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws", *Journal of Law and Economics*, 41, 1, (1998): 1–36.

⁷⁴⁰ *Ibid*

⁷⁴¹ Helderman, L.C., *National and state banks: a study of their origins*, (London: Google ebook, 1980).

⁷⁴² Grant, N. S., & Whitman, D.A., "Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act", *Duke Law Journal*, 53, 5, (2004): 1399–1514.

⁷⁴³ Ghent, A.C., & Kudlyak, M., "Recourse and Residential Mortgage Default: Evidence from U.S. States", *Review of Financial Studies*, 24, 9, (2011): 3149-3186.

⁷⁴⁴ *Ibid*

⁷⁴⁵ *Ibid*

Hindu script rejects fraudulent and deceptive mortgage.⁷⁴⁶ Critics of mortgaging engaged in severe condemnation of people who took advantage of the mortgage process by charging excessive interest.⁷⁴⁷ Dante's *Inferno* states that people who engage in usury have a special place in the 7th circle of hell. God has also condemned money lending in Jewish law.⁷⁴⁸ The America Law Register states that the history of mortgaging dates back to sacred Talmudic scriptures.⁷⁴⁹ It states that the ancient Greeks and Roman civilisations took these concepts from Judaic sources.⁷⁵⁰ The Romans in fact introduced the concept of debt security by assigning possession of property to the lender, even whilst the debtor remained in control of it until the debt was repaid.⁷⁵¹ The Jewish influence on mortgaging has influenced all societies who have made use of money lending practices.⁷⁵²

6.2.2 US Asset-Backed Securities Regulations

The growth of the United States Mortgage markets took place between 1949 and the end of the 20th century.⁷⁵³ The mortgage debt to income ratio increased significantly from 20 to 73% during this time.⁷⁵⁴⁷⁵⁵ The mortgage debt to household assets ratio increased from 15 to 41%.⁷⁵⁶⁷⁵⁷ This rapid growth, which set the American market apart from the rest of the world was driven by the US Federal Government's intervention in mortgage based lending.⁷⁵⁸ The American mortgage is rooted in the establishment of the first legitimate commercial bank in 1781.⁷⁵⁹ The establishment of the bank along with the development of a new system of exchange

⁷⁴⁶ Dwyer, G.P., "Wildcat Banking, Banking Panics, and Free Banking in the United States", *Federal Reserve Bank of Atlanta Economic Review*, (1996): 1–20.

⁷⁴⁷ Ghent, A.C., "The Historical Origins of America's Mortgage Laws", (2012), <<http://ssrn.com/abstract=2171357>>

⁷⁴⁸ Glaeser, E., & Scheinkman, J., "Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws", *Journal of Law and Economics*, 41, 1, (1998): 1–36.

⁷⁴⁹ *Ibid*

⁷⁵⁰ *Ibid*

⁷⁵¹ Ghent, A.C., & Kudlyak, M., "Recourse and Residential Mortgage Default: Evidence from U.S. States", *Review of Financial Studies*, 24, 9, (2011): 3149-3186.

⁷⁵² Dewey, D.R., & Chaddock, R.E., *State Banking before the Civil War*, (United States National Monetary Commission, 1911).

⁷⁵³ Ashcraft, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Foundations and Trends in Finance*, 2, (2008): 191-309.

⁷⁵⁴ OECD, "Financial Contagion in the Era of Globalised Banking?", OECD Economics Department Policy Notes, No. 14, (2012), <<http://www.oecd.org/eco/monetaryandfinancialissues/50556019.pdf>>

⁷⁵⁵ An, X., Deng, Y., & Sanders, A. B., "Subordination Levels in Structured Financing", In Arnoud Boot and Anjan Thakor (eds.) *Corporate Finance*, (UK: Elsevier, 2008).

⁷⁵⁶ Nothwehr, E., "Part 5-VII: Post-Crisis Financial Regulatory Reform", (2010), <<http://ebook.law.uiowa.edu/ebook/sites/default/files/E-Book%205-7%20Revised.pdf>>

⁷⁵⁷ Mehran, H., & Stulz, M. R., "The Economics of Conflicts of Interest in Financial Institutions", *Journal of Financial Economics*, 85, 2, (2007): 267-296.

⁷⁵⁸ Boesch, R., *Banking Regulation*, (The European Lawyer: UK, 2012).

⁷⁵⁹ Sanders, A., "The subprime crisis and its role in the financial crisis", *Journal of Housing Economics*, 17, (2008): 254-261.

of bank notes, governmental interplay and reduced liability of the bankers generated an ever-increasing ripple effect in the US mortgage market.⁷⁶⁰

Mortgages were characterised by different interest rates, shorter maturities and higher down payments by the early 1990s.⁷⁶¹ Home owners, it is interesting to note renegotiated their mortgages every year before the Great Depression of the 1930s.⁷⁶² The modern mortgage market took shape after federal intervention at the time of the Great Depression.⁷⁶³ This intervention led to the establishment of the Home Owners Loan Corporation, the Federal National Mortgage Association and the Federal Housing Administration.⁷⁶⁴ The development of the Great Depression resulted in plummeting property values, destabilisation in the mortgage market and default by home owners on loans when borrowers refused to renew their mortgages.⁷⁶⁵ Approximately 10% of homes in the US were faced with foreclosure, resulting in constant pressure for holders to resell repossessed properties.⁷⁶⁶

The American mortgage market went through another huge upheaval in 2007-2008 with the occurrence of the subprime crisis.⁷⁶⁷ American banks driven by the urge of greater profits resorted to extremely risky borrowing and even riskier lending to people who clearly did not have the resources to satisfy their loan obligations.⁷⁶⁸ The inability of these borrowers to meet their mortgage obligations resulted in a spate of repossessions, slide in property prices and huge losses for US banks.⁷⁶⁹ The interconnectedness of the banking system resulted in banking panic

⁷⁶⁰ Llewellyn, D., “*The Global Banking Crisis and the Post-crisis Banking and Regulatory scenario*”, University of Amsterdam Research Papers in Corporate Finance, (2010), <<http://icffr.org/getdoc/9cdc391f-5d9b-4271-aaab-6c1eda54149f/David-Llewellyn---The-Global-Banking-Crisis-and-th.aspx>>

⁷⁶¹ Coval, J. D., Jurek, J., W., & Stafford, E., “The Economics of Structured Finance”, *Journal of Economic Perspectives*, 23, 1, (2009): 3-25.

⁷⁶² Gorton G., “The Subprime Panic”, *National Bureau of Economic Research Cambridge*, Working Paper 14398, (2008), <<http://www.nber.org/papers/w14398>>

⁷⁶³ Pelzer, P., *Risk, Risk Management and Regulation in the Banking Industry: The Risk to Come*, Routledge International Studies in Money and Banking, (UK: Routledge, 2012).

⁷⁶⁴ Economic Online, “*Banking Regulation*”, (2012), <http://economicsonline.co.uk/Business_economics/Banking+regulation.html>

⁷⁶⁵ Ashcraft, A., & Schuermann, T., “Understanding the Securitization of Subprime Mortgage Credit”, *Foundations and Trends in Finance*, 2, (2008): 191-309.

⁷⁶⁶ Babb, C. M., “*Regulatory Reforms after U.S. Economic Crisis Show Results*”, (2012), <<http://iipdigital.usembassy.gov/st/english/article/2012/07/201207279838.html#axzz26T8QzxGQ> on 10 Sep 2012>

⁷⁶⁷ Rajan, G. R., *Fractures Still Fault Lines: How Hidden Threaten the World Economy*, (Princeton University Press: Princeton, 2010).

⁷⁶⁸ An, X., Deng, Y., & Sanders, A. B., “Subordination Levels in Structured Financing”, In Arnoud Boot and Anjan Thakor (eds.) *Corporate Finance*, (UK: Elsevier, 2008).

⁷⁶⁹ Coval, J. D., Jurek, J., W., & Stafford, E., “The Economics of Structured Finance”, *Journal of Economic Perspectives*, 23, 1, (2009): 3-25.

across the US and Europe, a sharp credit squeeze, tremendous pressure on business organisations and an economic depression that carried on for two years and affected the complete world.⁷⁷⁰

The financial crisis was followed by widespread and in-depth investigation of its causes and to significant regulatory changes, especially in the accounting, disclosure and treatment of Asset Backed Securities (ABS).⁷⁷¹ Asset backed securities are developed by the purchasing and bundling of loans, like for example residential mortgage loans, auto loans, leases and commercial mortgage loans followed by the creation of securities backed by these assets, which are thereafter sold to investors.⁷⁷² These loan bundles are frequently segregated into separate securities with dissimilar levels of return and risk. The payments on these loans are first distributed to the holders of lower risk and lower interest carrying securities and thereafter to the holders of securities with higher risks.⁷⁷³ Most public offerings of these ABS are carried out through expedited SEC (Securities Exchange Commission) procedures, also termed as shelf offerings.⁷⁷⁴ ABS holders suffered significant losses during the financial crisis. Some areas of securitisation market, more so the market for non-governmental mortgage backed securities have been comparatively subdued, even dormant since then.⁷⁷⁵

The development of the crisis revealed that numerous investors lacked a comprehensive understanding of the risks that existed in the underlying mortgages within tools of securitised assets and specifically depended upon credit ratings that were associated by rating agencies.⁷⁷⁶ Rating agencies like Standards and Poor failed to correctly assess and grade these securitisation structures in many cases.⁷⁷⁷ The crisis also revealed an absence of transparency in the securitised pools, a scarcity of oversight by the senior managements of the issuing organisation, inadequate enforcement mechanisms concerned with representations and warranties made in underlying contracts and insufficient availability of time for investors to make well informed investment decisions.⁷⁷⁸

⁷⁷⁰ Ellinger, E. P., Lomnicka, E., & Hare, C., *Ellinger's Modern Banking Law*, 5th edition, (OUP: Oxford, 2010).

⁷⁷¹ Idier, J., Lamé, G., & Mésonnier, J.S., "How useful is the marginal expected shortfall for the measurement of systemic exposure: A practical assessment", *Journal of Banking and Finance*, 47, (2014): 134-146.

⁷⁷² *Ibid*

⁷⁷³ Huang, X., Zhou, H., & Zhu, H., "A framework for assessing the systemic risk of major financial institutions", *Journal of Banking and Finance*, 33, 11, (2009): 2036–2049.

⁷⁷⁴ *Ibid*

⁷⁷⁵ Hair, J.F., Sarstedt, M., Hopkins, L., & Kuppelwieser, V.G., "Partial least squares structural equation modeling (PLS-SEM): An emerging tool in business research", *European Business Review*, 26, 2, (2014): 106- 121.

⁷⁷⁶ *Ibid*

⁷⁷⁷ *Ibid*

⁷⁷⁸ Avkiran, N.K., & Cai, L., "Identifying distress among banks prior to a major crisis using non-oriented super-SBM", *Annals of Operations Research*, 217, (2014): 31-53.

The SEC engaged in in-depth examination of the inadequacies in the securitisation process and proposed a number of rules for devising the offering processes as well as the disclosure and reporting requirements for the ABS. The Dodd Frank Act, which was legislated after the proposal addressed some of the ABS concerns expressed by the SEC.⁷⁷⁹ The US regulatory responses to securitisation were primarily incorporate in the Dodd Frank Act and to some extent in the US implementation of the Basel III capital requirements.⁷⁸⁰ Conceptually these responses can be categorised into four segments, (a) enhancing disclosure, (b) requiring risk retention, (c) reforming the working of rating Agencies and (d) imposing capital requirements.⁷⁸¹

With regard to disclosure, Section 942B of the Dodd Frank Act stipulates that disclosure of information be made for each issue of ABS with regard to the financial assets backing each class of their securities.⁷⁸² The Dodd Frank Act has focused on risk retention by attempting to address the moral hazard resulting from the originate-to-distribute model of loan origination, wherein lenders fell the loans as and when they are made, thereby enhancing the quality of the financial assets that underlie security transactions.⁷⁸³ The Dodd Frank Act requires securitisers, who effectively originate or sponsor securitisation to retain a specific portion of the credit risk for any financial asset, including mortgage loans, which the securitiser transfers, sells or conveys to a third party through the issuance of an asset backed security.⁷⁸⁴ The regulations furthermore prohibit securitisers from hedging or transferring the credit risk, which they are required to retain with respect to an asset.⁷⁸⁵ With regard to reform of rating agencies the Dodd Frank act has called upon the SEC to prescribe regulations requiring each recognised statistical rating organisation to include in every report that accompanies a credit rating, a detailed description of the representations, warranties and enforcement mechanisms that are available to investors and the ways in which these differ from the representations, warranties and enforcement mechanisms

⁷⁷⁹ Baker, C., “The Federal Reserve as last resort”, *University of Michigan Journal of Law Reform*, 46, 1, (2012): 69-133.

⁷⁸⁰ Erel, I., Nadauld, T., & Stultz, R.M., “Why did holdings of highly rated securitization tranches differ so much across banks?”, *The Review of Financial Studies*, 27, 2, (2014): 404-453.

⁷⁸¹ Avkiran, N.K., & Cai, L., “Identifying distress among banks prior to a major crisis using non-oriented super-SBM”, *Annals of Operations Research*, 217, (2014): 31-53.

⁷⁸² Idier, J., Lamé, G., & Mésonnier, J.S., “How useful is the marginal expected shortfall for the measurement of systemic exposure: A practical assessment”, *Journal of Banking and Finance*, 47, (2014): 134-146.

⁷⁸³ *Ibid*

⁷⁸⁴ Chernenko, S., & Sunderam, A., “Frictions in shadow banking: evidence from the lending behavior of money market mutual funds”, *The Review of Financial Studies*, 27, 6, (2014): 1717-1750.

⁷⁸⁵ *Ibid*

in the issuance of similar securities.⁷⁸⁶ The act has also significantly reduced reliance on rating agencies by banks and federal agencies.⁷⁸⁷

The Dodd Frank Act has furthermore focused upon capital requirements to protect firms against economic shocks.⁷⁸⁸ The capital requirements require investors in ABS to hold more capital than they would be called upon to hold for investments in other types of securities.⁷⁸⁹ The Federal Reserve and two other federal agencies have also adopted a final rule combining Basel III capital requirements and the Dodd Frank framework to implement Basel III's Liquidity Coverage Ratio (LCR) in the United States.⁷⁹⁰ The LCR calls upon banks to maintain a specific minimum quality of high quality liquid assets that can be converted into cash without loss of value to withstand a 30 day stress scenario.⁷⁹¹ A banks stock of such assets must equal its total net cash outflows over the 30 days stress period.⁷⁹²

The SEC carried out some modification of its original proposals in light of the Dodd Frank Act and comments received from the public on the 2010 proposal in July 2011.⁷⁹³ The commission reopened the comment period on the proposal in February 2014 to allow interested persons to provide opinions on an approach for the dissemination of data at the loan level.⁷⁹⁴ The proposals aimed to address the different concerns that had emerged after the financial crisis by calling for additional disclosures, including the filing of computer friendly and standardised loan level information, the revision of ABS shelf eligibility criteria and the replacement of investment grade ratings requirement with alternative criteria and the carrying out of other revisions.⁷⁹⁵

The SEC subsequently, in August 2014 adopted various revisions to rules governing the processes for disclosure, reporting and offering for asset backed securities in order to improve transparency, enhance investor protection and facilitate capital formation in the securitisation

⁷⁸⁶ Calluzzo, P., & Dong, G.N., "Has the financial system become safer after the crisis? The changing nature of financial institution risk", *Journal of Banking and Finance*, 53, (2015): 233-248.

⁷⁸⁷ Berger, A.N., & Bouwman, C.H.S., "How does capital affect bank performance during financial crises?", *Journal of Financial Economics*, 109, (2013): 146-176.

⁷⁸⁸ Calluzzo, P., & Dong, G.N., "Has the financial system become safer after the crisis? The changing nature of financial institution risk", *Journal of Banking and Finance*, 53, (2015): 233-248.

⁷⁸⁹ *Ibid*

⁷⁹⁰ Chernenko, S., & Sunderam, A., "Frictions in shadow banking: evidence from the lending behavior of money market mutual funds", *The Review of Financial Studies*, 27, 6, (2014): 1717-1750.

⁷⁹¹ *Ibid*

⁷⁹² *Ibid*

⁷⁹³ **Erel, I., Nadauld, T., & Stultz, R.M., "Why did holdings of highly rated securitization tranches differ so much across banks?", *The Review of Financial Studies*, 27, 2, (2014): 404-453.**

⁷⁹⁴ Allen, L., Bali, T.G, & Tang, Y., "Does systemic risk in the financial sector predict future economic downturns?", *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

⁷⁹⁵ Glasserman, P., & Young, H.P., "How likely is contagion in financial networks?", *Journal of Banking and Finance*, 50, (2015): 383-399.

market.⁷⁹⁶ The new rules require, *inter alia* disclosure at the loan levels for specific assets, like residential and commercial mortgages and automobile loans.⁷⁹⁷ The rules also gave more time to investors for reviewing and considering securitisation offerings; they have revised the eligibility criteria for using expedited offering processes and have made important changes to reporting requirements.⁷⁹⁸ Skadden stated that the new rules for publicly issued ABS will put barriers in the offering process, introduce new parties to ABS transactions and call upon certain asset classes to provide substantially greater details on the underlying asset pools.⁷⁹⁹

6.2.3 **Shelf Eligibility**

The new rules effectively replace eligibility requirements for using or shelf registration statement including that the offered securities be provided an investment grade rating by a nationally well-known organisation engaged in a statistical rating work.⁸⁰⁰ These provisions include certification from the deposits CEO covering familiarity with the prospectus, the assets, the material transaction documents and the structure; certification must have a statement by the CEO that he or she has reasonable basis to state that the securitisation has been structured appropriately to produce cash flows in quantities adequate for the servicing of scheduled payments.⁸⁰¹ The transaction document also provide for the appointment of an asset representation reviewer.⁸⁰² The transaction documents furthermore include a mechanism for accommodation of requests by investors and for resolution of disputes.⁸⁰³

6.2.3.1 **Asset Level Data**

The new rules call upon organisations engaged in issuance of ABS supported by residential mortgages, auto loans and leases, commercial mortgages and debt securities to make

⁷⁹⁶ Hair, J.F., Sarstedt, M., Hopkins, L., & Kuppelwieser, V.G., “Partial least squares structural equation modeling (PLS-SEM): An emerging tool in business research”, *European Business Review*, 26, 2, (2014): 106- 121.

⁷⁹⁷ Avkiran, N.K., & Cai, L., “Identifying distress among banks prior to a major crisis using non-oriented super-SBM”, *Annals of Operations Research*, 217, (2014): 31-53.

⁷⁹⁸ Glasserman, P., & Young, H.P., “How likely is contagion in financial networks?”, *Journal of Banking and Finance*, 50, (2015): 383-399.

⁷⁹⁹ Skadden, “*Regulation AB: New Rules for Publicly Issued Asset-Backed Securities*”, (2015), <<https://www.skadden.com/insights/regulation-ab-new-rules-publicly-issued-asset-backed-securities>>

⁸⁰⁰ Huang, X., Zhou, H., & Zhu, H., “A framework for assessing the systemic risk of major financial institutions”, *Journal of Banking and Finance*, 33, 11, (2009): 2036–2049.

⁸⁰¹ *Ibid*

⁸⁰² Idier, J., Lamé, G., & Mésonnier, J.S., “How useful is the marginal expected shortfall for the measurement of systemic exposure: A practical assessment”, *Journal of Banking and Finance*, 47, (2014): 134-146.

⁸⁰³ *Ibid*

available standardised asset level data in both periodic reports and prospectuses.⁸⁰⁴ The quantum of data required is substantially higher than the amount disclosed under current requirements.⁸⁰⁵ Adherence to these rules will thus require substantially greater effort from issuers, with specific regard to assembly and verification of required information.⁸⁰⁶

The SEC has also indicated that certain items, which have been proposed in 2010 but have not been covered in the final rules still, have to be addressed.⁸⁰⁷⁸⁰⁸ These include the following.

- Asset level data requirements for asset classes that are not subject to this requirement in the final rules as well as grouped account data requirement for credit card ABS.⁸⁰⁹
- Various disclosure requirements for the private offerings of ABS.⁸¹⁰
- The cash flow provisions for every ABS transaction, making use of a waterfall computer programme.⁸¹¹

6.3 EU Securitisation Regulations

The European regulatory response to securitisation can be categorised into five segments, namely enhancement of disclosure, reforming of rating agency, requiring risk retention and requiring a certain amount of due diligence.⁸¹² The EU response to regulation of securitisation is by and large similar to that of the US and additionally requires due diligence.⁸¹³ The European parliament and council proposed regulations in September 2015 for the creation of common rules and securitisation and the development of a European framework for Simple, Standardised and

⁸⁰⁴ Allen, L., Bali, T.G, & Tang, Y., “Does systemic risk in the financial sector predict future economic downturns?”, *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

⁸⁰⁵ *Ibid*

⁸⁰⁶ Beltratti, A., & Stulz, R.M., “The credit crisis around the globe: Why did some banks perform better?”, *Journal of Financial Economics*, 105, 1, (2012): 1-17.

⁸⁰⁷ Anabtawi, I., & Schwarcz, S.L., “Regulating Systemic Risk: Towards an Analytical Framework”, 86 *Notre Dame Legal Review*, 86, 4, (2011): 1349-1412.

⁸⁰⁸ *The SEC revised existing regulations about asset backed securities in 2014 and completed them finally in 2016. The new rules provided measures for all the issues that were pending from 2010.*

Faulkner, A.M., “*Regulation AB: New Rules for Publicly Issued Asset-Backed Securities*”, (2015)

<<https://www.skadden.com/insights/publications/2015/01/regulation-ab--new-rules-for-publicly-issued-asset>>

⁸⁰⁹ *Ibid*

⁸¹⁰ Calomiris, C., & Herring, R., “How to Design a Contingent Convertible Debt Requirement that Solves Our Too-Big-To-Fail Problem,” *Journal of Applied Corporate Finance*, 25, 2, (2013): pp. 1-19.

⁸¹¹ *Ibid*

⁸¹² Erel, I., Nadauld, T., & Stultz, R.M., “Why did holdings of highly rated securitization tranches differ so much across banks?”, *The Review of Financial Studies*, 27, 2, (2014): 404-453.

⁸¹³ *Ibid*

Transparent Securitisation (STS).⁸¹⁴ An important objective of these regulations was to incentivise STS securitisation and make use of it as an effective funding channel for the economy.⁸¹⁵

The EU position on securitisation focuses upon the five elements described above. With regard to disclosure, the incentivisation of STS securitisation aims to promote disclosure.⁸¹⁶ Disclosure is likely to be far more effective for securitisation that are simple, transparent and standardised compared to complex securitisation transaction.⁸¹⁷ Chapter 3 of the proposed regulations describes the simplicity requirement, which includes a true sale or a similar transfer of underlying financial assets.⁸¹⁸ These financial assets must also meet the requirements of simplicity in terms of homogeneity, credit worthiness and not being part of already securitised financial assets.⁸¹⁹ Article 9 of chapter 3 states that interest rate risk and exchange rate risk must be hedged and that the underlying financial assets cannot include or be supported by derivatives other than for such hedging.⁸²⁰ The transaction documentation must furthermore clearly specify the obligations, duties and responsibilities of the servicer and the backup servicer for ensuring continuous, efficient and effective servicing of the financial assets.⁸²¹ Chapter 3 also states transparency requirements including the need of the sponsor to provide investors with a cash flow model and adequate information on historical default, delinquency and loss performance for similar financial assets to those being securitised.⁸²²

6.4 Comparison of US and EU Securities Regulations

The development of the financial crisis resulted in significant changes in the regulation of securities in the EU and the US. The market in financial Instruments Directive 2004 / 39/ EC (MiFID) was enforced in November 2007 in the EU and brought about substantial changes in the

⁸¹⁴ Anabtawi, I., & Schwarcz, S.L., “Regulating Systemic Risk: Towards an Analytical Framework”, 86 *Notre Dame Legal Review*, 86, 4, (2011): 1349-1412.

⁸¹⁵ *Ibid*

⁸¹⁶ *Ibid*

⁸¹⁷ *Ibid*

⁸¹⁸ *Ibid*

⁸¹⁹ *Ibid*

⁸²⁰ Allen, L., Bali, T.G, & Tang, Y., “Does systemic risk in the financial sector predict future economic downturns?”, *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

⁸²¹ Erel, I., Nadauld, T., & Stultz, R.M., “Why did holdings of highly rated securitization tranches differ so much across banks?”, *The Review of Financial Studies*, 27, 2, (2014): 404-453.

⁸²² Calluzzo, P., & Dong, G.N., “Has the financial system become safer after the crisis? The changing nature of financial institution risk”, *Journal of Banking and Finance*, 53, (2015): 233-248.

market infrastructure.⁸²³ The USA reformed its markets in 2007 and brought about further changes in 2010, 2014 and 2016. The role of securitisation in mortgage markets is more developed in the USA than in Europe.⁸²⁴ Securitisation involves the bundling of mortgages and their resale in order to make them tradable.⁸²⁵ Such securitisation provides several advantages, namely greater efficiency in the use of capital, higher liquidity than in a non-securitised system and the possibility of enhancement of risk management.⁸²⁶ Securitisation has however not grown very rapidly in Europe on account of specific reasons.⁸²⁷ The process is costly and capital intensive; with mortgage backed securities issues being more expensive, preference is still given to competitive on-balance sheet funding instruments.⁸²⁸ The EC treaty outlaws state aid in the form of guarantees in order to prevent unfair competition.⁸²⁹ The MBS market in Europe is also disadvantaged on account of legal complexities and lack of standardisation.⁸³⁰

6.5 Conclusions

This section provides details about the legal framework for mortgages in the USA and the European Union. Such information thus becomes a reference firm for the legal position on mortgages in the chosen states of Sharjah, Dubai and Saudi Arabia. The investigation carried out for this study reveal that the mortgaging activity in the USA has evolved considerably over the course of the 19th and 20th centuries and matured after the occurrence of the great depression of the 1940s. The American mortgage market has thus been characterised by two hugely unsettling events, namely the great depression of the 1940s and the subprime crisis of 2008-2009. The investigation carried out by governments appointed investigators and the experts resulted in the enactment of the Dodd Frank Act, which introduced several restrictions on the development and sale of mortgage backed securities. The American SEC has also introduced several new regulations that call for disclosure by bank of loan level for specific assets, like commercial mortgages and residential mortgages as well as automobile loans. Europe also responded to the

⁸²³ Allen, L., Bali, T.G, & Tang, Y., “Does systemic risk in the financial sector predict future economic downturns?”, *The Review of Financial Studies*, 25, 10, (2012): pp. 3000-36.

⁸²⁴ *Ibid*

⁸²⁵ *Ibid*

⁸²⁶⁸²⁶ Erel, I., Nadauld, T., & Stultz, R.M., “Why did holdings of highly rated securitization tranches differ so much across banks?”, *The Review of Financial Studies*, 27, 2, (2014): 404-453.

⁸²⁷ *Ibid*

⁸²⁸ *Ibid*

⁸²⁹ Calomiris, C., & Herring, R., “How to Design a Contingent Convertible Debt Requirement that Solves Our Too-Big-To-Fail Problem,” *Journal of Applied Corporate Finance*, 25, 2, (2013): pp. 1-19.

⁸³⁰ *Ibid*

threat of securitisation by bringing in norms and standards for greater disclosure, risk retention and due diligence. The asset backed securities market in Europe, however, lags behind that of the US because of the availability of on-balance sheet financing options and lack of standardisation between the mortgaging practices of different countries. The following sections contain details about mortgage laws and securitisation, as they exist in UK, Sharjah, Saudi Arabia and Dubai.

Chapter 5: Case Studies

7.1 Introduction

This section contains information on Islamic banking, with particular regard to mortgages and securitisation in UK, Sharjah, Saudi Arabia and Dubai. The information for this section has been accessed separately for UK, Sharjah, Saudi Arabia and Dubai and thereafter blended in a common conclusion in order to arrive at a holistic picture of Islamic financing, mortgages and securitisation in the UAE.

7.2 UK Case Study

7.2.1 The Regulation of Islamic Mortgages within the UK

The Islamic financial industry is perceived to be one of the most innovative and fastest growing industries within the UK.⁸³¹ As stated by Ed Balls in 2007, the aim of the UK government is to make the UK a ‘global centre for Islamic finance’, an aim that is supported by the government’s efforts to shape ‘the tax and regulatory framework to allow for the development of Islamic finance products’, dating from the establishment of the Finance Act 2003.⁸³² These sentiments were echoed by Sir Howard Davies during his tenure as Chairman of the Financial Services Authority (FSA),⁸³³ when he stated that “he had no objection in principle to the idea of an Islamic bank in the UK”.⁸³⁴ On the condition that Islamic banks were in accordance with the regulatory requirements laid out by the FSA, it was stated that the introduction of Islamic financial institutions would be ‘good for Muslim consumers, good for innovation and diversity in our markets and good for London as an international financial centre’.⁸³⁵ One of the most commonly cited examples of the way in which Islamic financial products have been allowed to proliferate within the UK system of financial legislation is the

⁸³¹ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

⁸³² Alexakis, C., & Tsikouras, A., “Islamic finance: regulatory framework – challenges lying ahead”, *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 2, (2009): 90-104.

⁸³³ Financial Services Authority, “*Conference on Islamic Banking and Finance Bahrain*”, (2003), <<http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP118.shtml>>

⁸³⁴ Alexakis, C., & Tsikouras, A., “Islamic finance: regulatory framework – challenges lying ahead”, *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 2, (2009): 90-104.

⁸³⁵ Financial Services Authority, “*Conference on Islamic Banking and Finance Bahrain*”, (2003), <<http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2003/SP118.shtml>>

removal of the double stamp duty land tax which was previously levied on *Ijara* and *Murabaha* mortgages in 2003.⁸³⁶

Whilst Islamic banking has grown to some extent in the UK, driven by the efforts of banks and a significant Muslim population, several problems have been experienced by Islamic banking customers.⁸³⁷ Goddard stated that Islamic banking is supposed to be a fundamental paradigm shift from lending to an individual where he is exposed to all the risks of the venture and where the banks simply takes its fix return to a situation where the bank is perceived to be a partner in the venture and consequently shares in the risks associated with the transaction.⁸³⁸ This is however contradicted by specific factors. Islamic mortgages available in the UK require the buyer to take out house insurance on the property so that everyone is covered in the case of an untoward accident.⁸³⁹ The Islamic bank also calls upon the customer to maintain the house and make sure of its general upkeep.⁸⁴⁰ Some banks layout several different agreement for the customers to sign up; these are in the nature of service agreement.⁸⁴¹ Eisenberg and Nethercott stated that if the Islamic bank actually owned 80% of the house then a general understanding of house ownership and partnership in business would suggest that costs were divided in a ratio of 80:20 in case of home insurance and general upkeep.⁸⁴² Banks also ask customers to pay stamp duty upon the purchase of the house, which again contradicts sharing of the ownership costs of the property.⁸⁴³ Ercanbrack stated that Islamic banks also do not expose themselves fully to the uncertainties of the open market.⁸⁴⁴ In Islamic mortgages, a locked in pricing occurs in the quarterly or half early or even annual buyback of a percentage in the house.⁸⁴⁵ The bank agrees with the customer right in the beginning that the house will be sold in stages at the same price as it was purchased, right in the beginning of the mortgage.⁸⁴⁶ This however works against the customer when the price of a house goes down after the initial agreement.⁸⁴⁷ Whilst Islamic law

⁸³⁶ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

⁸³⁷ Goddard, A., "The Mortgage Credit Directive: how will this impact UK lenders?", (2014),

<http://www.addleshawgoddard.com/view.asp?content_id=7360&parent_id=6606>

⁸³⁸ *Ibid*

⁸³⁹ *Ibid*

⁸⁴⁰ Dar, A.H., & Moghul, U.F., *The chancellor guide to the legal and Sharia aspects of Islamic finance*, (Cambridge: Cambridge University Press, 2009).

⁸⁴¹ *Ibid*

⁸⁴² Eisenberg, D., & Nethercott, C., *Islamic finance: law and practice*, (London: Routledge Publishers, 2012).

⁸⁴³ *Ibid*

⁸⁴⁴ Ercanbrack, J., "The regulation of Islamic finance in the United Kingdom", *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁸⁴⁵ *Ibid*

⁸⁴⁶ *Ibid*

⁸⁴⁷ *Ibid*

states that the banks and the client must participate equally in the sharing of profits and losses, which does not seem to be followed in practice by Islamic banks at least in the UK.⁸⁴⁸

7.2.2 UK Non-Discriminatory Regime

Various studies have been published that examine the way in which Islamic mortgages are regulated within the UK. The Financial Services and Markets Act 2000 has, since 2004, overseen the regulation of all mortgage administration, advising, arranging and lending within the UK, in addition to certain forms of mortgage advertising.⁸⁴⁹ Section 19 of the FSMA stipulates that any individual who conducts a regulated activity within the USA must have either received authorisation from the FSA or must be exempt; a breach of such a clause constitutes a criminal offence.⁸⁵⁰ Prior to the establishment of the FSA as the UK's sole financial regulator, different financial markets were overseen by separate financial regulators. Specifically, the supervision of banks under the Banking Act 1987 was overseen by the Bank of England, and the regulation of investment was carried out by the Securities and Investment Board, in accordance with the 1986 Financial Services Act.⁸⁵¹

Islamic financial institutions are currently licensed to operate as UK institutions; all of the transactions that are conducted by Islamic banks are determined by English law.⁸⁵² The UK operates a non-discriminatory regime whereby all of the financial institutions that operate in the UK and which are authorised by the FSA are required to operate according to the same standards.⁸⁵³ Such standards are held to apply irrespective of the institution's country of origin, the religious principles of the institution, or the sector within which the institution specialises.⁸⁵⁴ This is stipulated within the six Principles of Good Regulation laid out within the FSMA, the aim of which is to encourage innovation and to avoid the implementation of unnecessary barriers to expansion or to entry within the financial markets.⁸⁵⁵ Consequently, the same standards are applied to Islamic financial institutions in the UK as for their non-Islamic counterparts; this is

⁸⁴⁸ Freshfields Bruckhaus Deringer, F.B., "*Islamic Finance: Basic principles and Structures. A focus on Project Finance*", (2006), <<http://www.nzibo.com/IB2/basicPS.pdf>>

⁸⁴⁹ FSMA, (Regulated Activities) Order 2001, S. I.2001/554, Arts. 61, 25A, 53A (2000).

⁸⁵⁰ *Ibid*

⁸⁵¹ Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A., "*Islamic finance in the UK: regulation and challenges*", (2007), <<http://media4.efinancialnews.com/share/media/downloads/2007/11/2349281881.pdf>>

⁸⁵² Aldohni, A.K., *The legal and regulatory aspects of Islamic banking*, (London: Routledge Publishers, 2012).

⁸⁵³ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁸⁵⁴ Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A., "*Islamic finance in the UK: regulation and challenges*", (2007), <<http://media4.efinancialnews.com/share/media/downloads/2007/11/2349281881.pdf>>

⁸⁵⁵ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

summarised by Howard Davies in his description of the FSA's approach as 'no obstacles, but no special favours'.⁸⁵⁶

7.2.3 Difficulties Regulating Islamic Financial Institutions within the UK Legislative Framework and Implications for Sharia Compliance

Various studies have been conducted into the regulatory difficulties that are presented by Islamic financial institutions within the UK legislative framework. Kettell argues that one of the most significant legislative challenges which are posed by Islamic financial products in regulatory terms is the way in which such products should be defined.⁸⁵⁷ Given that the structure of Islamic products is rooted in the principles which are outlined within the Koran, the underlying structure of such products may differ significantly from their non-Islamic equivalents, despite having a similar economic effect.⁸⁵⁸ This can be seen in the case of the *Murabaha* Islamic mortgage, which, while also being used for the purchase of property by individuals, differs substantially in terms of its structure from non-Islamic mortgages.⁸⁵⁹ Consequently, the definition of Islamic financial products according to the Regulated Activities Order may differ from the definitions of their non-religious equivalents⁸⁶⁰ Confusion over the definition of Islamic financial products may have an implication for Islamic financial institutions that need to ensure that they are applying for the correct scope of permission for the activities that they wish to carry out.⁸⁶¹ In addition, the regulatory definition of a product plays an important role in deciding the framework within which different products can be sold; in the case that an Islamic financial product is excluded from the FSA's regulatory framework; restrictions may be imposed on the parties to whom the product can be sold.⁸⁶²

A case study of a situation in which confusion arose concerning the regulatory definition of an Islamic financial product can be seen in the case of the Islamic Bank of Britain that was authorised by the FSA in August 2004.⁸⁶³ The bank consisted of the first fully Islamic bank in a majority non-Muslim country. The key challenge arose over the definition of a deposit, which,

⁸⁵⁶ Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A., "Islamic finance in the UK: regulation and challenges", (2007), <<http://media4.efinancialnews.com/share/media/downloads/2007/11/2349281881.pdf>>

⁸⁵⁷ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

⁸⁵⁸ Colon, J.C., "Choice of law and Islamic finance", *Texas International Law Journal*, 46, 2, (2011): 411-435.

⁸⁵⁹ *Ibid*

⁸⁶⁰ *Ibid*

⁸⁶¹ Ercanbrack, J., "The regulation of Islamic finance in the United Kingdom", *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁸⁶² *Ibid*

⁸⁶³ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

under UK regulation, is defined as consisting of a ‘sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by parties’.⁸⁶⁴ Determining the regulatory definition of such a product is important since it is important for the customer to be assured that he will be fully repaid as long as the bank is solvent.⁸⁶⁵ Confusion arose over the proposed launching of a savings account that was referred to by the IBB as a ‘deposit’, but which was in fact a *Mudaraba*, or profit and loss sharing account whereby it would be necessary for the risk of losing the original capital to be borne by the customer.⁸⁶⁶ This conflicted with the way in which a deposit was defined by the FSA as being something which requires capital certainty. The solution that was arrived at by the FSA was to require the IBB to state legally that all of its depositors were entitled to full repayment, thus ensuring that it was in compliance with the requirements of the FSA.⁸⁶⁷ However, it was possible for the clients of the IBB to reject deposit protection due to religious reasons and to opt for repayment on the basis of the *Sharia* compliant system of risk sharing.⁸⁶⁸

Another difficulty that is associated with the regulation of Islamic financial institutions within UK law is in applying the appropriate regulation to the *Sharia* Supervisory Board (SSB).⁸⁶⁹ As highlighted by the FSA, the role of the *Sharia* Supervisory Board is to ensure that all of the transactions and products which are provided by an Islamic financial institution are compliant with the *Sharia* principles that are outlined within the Koran (Wilson, 2012).⁸⁷⁰ In cases where the scholars are satisfied with the *Sharia* compliance of a product, they issue an approval. However, the fact that the FSA fulfils a secular, and not a religious, role, means that it is not possible for the FSA to distinguish between different interpretations of Islamic law and to provide consumers with any assurance of whether the products which they are purchasing are in fact *Sharia* compliant. This is expanded upon by Ahmad and Hassan, who argue that the *Sharia* Supervisory Board can cause regulatory confusion since the precise nature of their role, and

⁸⁶⁴ The Stationery Office Limited, “*The Banking Act 1987 (Exempt Transactions) (Amendment) Regulations 1990 s.20*”, (1998), <http://www.legislation.gov.uk/ukpga/1987/22/pdfs/ukpga_19870022_en.pdf>

⁸⁶⁵ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁸⁶⁶ Aris, N.A., Othman, R., Azli, R.M., Sahri, M., Razak, D.A., & Rahman, Z.A., “Islamic banking products: regulations, issues and challenges”, *The Journal of Applied Business Research*, 29, 4, (2013): 7-19.

⁸⁶⁷ *Ibid*

⁸⁶⁸ *Ibid*

⁸⁶⁹ Khan, M.F., & Porzio, M., *Islamic banking and finance in the European Union: A challenge*, (London: Routledge Publishers, 2010).

⁸⁷⁰ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

whether it is executive, or purely advisory in nature, is often unclear.⁸⁷¹ The implications of this confusion are far-reaching, since UK legislation stipulates that any individual who performs the role of Director of an authorised firm must comply with the rules associated with the FSA Approved Persons.⁸⁷² This requires them to pass the FSA's 'Fit and Proper Test for Approved Persons', which assess factors such as the competence and capability of the person (Foster, 2006).⁸⁷³ In other words, if the *Sharia* scholar in question were judged to have an executive role and to therefore occupy a directorship role, it would be necessary for them to demonstrate that he had relevant experience. Furthermore, if *Sharia* scholars were considered to be directors, their active participation within the company's business is likely to qualify them as an Executive Director, rather than Non-Executive Director.⁸⁷⁴

In such a situation, the occupation of such roles on the *Sharia* Supervisory Boards of multiple financial institutions would represent significant conflict of interest, and would not be permitted by the FSA.⁸⁷⁵ In order to avoid such complications, it is therefore necessary for Islamic financial institutions to demonstrate that the scholars who sit on the *Sharia* Supervisory Boards play a purely advisory role and do not play an active role in the management of the company. This is often determined by an examination by the FSA of the board's governance structure, the fee structure, and their reporting lines.⁸⁷⁶ According to Ahmad and Hassan, this issue is likely to be complicated further by the fact that *Sharia* scholars need to become more involved in the process of product development within Islamic financial institutions, so that such institutions are more conducive to the development of complicated *Sharia* compliant financial products which can enable such institutions to compete effectively.⁸⁷⁷ Whilst this may help to increase the competitiveness of institutions, it is likely to increase the executive nature of the role of the *Sharia* Supervisory Board, thus giving rise to the aforementioned complications.⁸⁷⁸

⁸⁷¹ Ahmad, A.U.F., & Hassan, K., "Legal and regulatory issues of Islamic finance in Australia", *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 4, (2009): pp. 305-322.

⁸⁷² Alexakis, C., & Tsikouras, A., "Islamic finance: regulatory framework – challenges lying ahead", *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 2, (2009): 90-104.

⁸⁷³ Foster, N.H.D., "Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts", *Amicus Curiae Issue*, 68, 5, (2006): pp.1-7.

⁸⁷⁴ Ercanbrack, J., "The regulation of Islamic finance in the United Kingdom", *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁸⁷⁵ Ahmad, A.U.F., & Hassan, K., "Legal and regulatory issues of Islamic finance in Australia", *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 4, (2009): pp. 305-322.

⁸⁷⁶ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

⁸⁷⁷ Ahmad, A.U.F., & Hassan, K., "Legal and regulatory issues of Islamic finance in Australia", *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 4, (2009): pp. 305-322.

⁸⁷⁸ *Ibid*

A series of semi structured interviews which were conducted by Wilson among ten scholars of Islamic finance also highlight financial promotions as being a potential source of confusion.⁸⁷⁹ The requirement which is outlined by the FSA with reference to financial promotions is that they should be ‘clear, fair and not misleading’.⁸⁸⁰ This is of particular importance within an Islamic context, given the newness of Islamic financial products, the difference of their underlying structure, and consequently, their potential to cause confusion among consumers who are used to conventional financial products.⁸⁸¹

7.2.4 The Extent of *Sharia* Compliance by Islamic Financial Institutions in the UK

Whilst there has been no rigorous statistical research that has been conducted into the extent of *Sharia* compliance by UK based Islamic financial institutions, a report prepared by Sheikh Muhammad Taqi Usmani from the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIOFI), which is responsible for establishing the standards for the global Islamic industry, suggested that as much of 85 per cent of Islamic financial products are un-Islamic.⁸⁸² This is supported by the findings of a survey conducted by Wilson of five Islamic financial institutions in Europe which suggests that only a quarter of the financial products which are provided are strictly *Sharia* compliant.⁸⁸³ While it is important to bear in mind that Usmani’s comments relate to the global provision of Islamic financial products, rather than just to the UK, and that the small sample size of Wilson’s survey may limit the extent to which those results may be generalised, investigating the *Sharia* compliance of Islamic financial products in the UK is nevertheless worthwhile.⁸⁸⁴

The majority of studies which have examined the issue of *Sharia* compliance by Islamic financial institutions in the UK suggest that the extent of *Sharia* compliance may be affected by the independence of the *Sharia* Supervisory Board. This can be seen in a study conducted by Casper who conducts a detailed literature review pertaining to the operation of *Sharia* Supervisory Boards in the UK and Germany.⁸⁸⁵ In particular, it is suggested that concerns about

⁸⁷⁹ Wilson, R., *Islamic Finance in Europe*, (Florence: Robert Schuman Centre for Advanced Studies, 2007).

⁸⁸⁰ Ercanbrack, J., “The regulation of Islamic finance in the United Kingdom”, *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁸⁸¹ *Ibid*

⁸⁸² Foster, N.H.D., “Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts”, *Amicus Curiae Issue*, 68, 5, (2006): pp.1-7.

⁸⁸³ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁸⁸⁴ *Ibid*

⁸⁸⁵ Casper, M., “Sharia boards and sharia compliance in the context of European corporate governance”, *Centrum fur Religion Und Moderne*, 8, 33, (2012): 15-33.

the *Sharia* compliance of financial institutions may be due to the fact that there is no system of standardised education for scholars of Islamic law, and it is therefore not possible to assess the level of expertise that a *Sharia* scholar has. As a result, the number of *Sharia* scholars who combine a detailed understanding of *Sharia* principles with sufficient knowledge of economics or finance is limited.⁸⁸⁶ Consequently, it is not uncommon for the same few individuals to sit on the boards of multiple companies; the results of a survey conducted by Foster reveals that one scholar, Nizam Yaqubi, currently sits on the boards of 85 different *Sharia* boards (Foster, 2006).⁸⁸⁷ As argued by Foster, the inclusion of the individual on the boards of several different, competing companies are likely to result in conflict of interest.⁸⁸⁸

These findings are supported by a survey conducted by Funds@work which argues that scholars who are appointed, and paid by, the managers of financial institutions in order to determine the *Sharia* compliance of their products represents an irresolvable conflict of interest.⁸⁸⁹ This is due to the fact that scholars are arguably more likely to rule that products are *Sharia* compliant if they are being paid significant salaries by their employer institution. Furthermore, some *Sharia* scholars are compensated in basis points which are determined on the basis of the number of funds are managed; this is likely to give rise to a conflict of interest between the need for a scholar to get paid for his services, whilst also maintaining both actual and perceived independence.⁸⁹⁰ This concern is echoed by the Secretary General of the AAOIFI, Dr Nedal Alchaar, who argues that there is currently ‘a potential case for conflict of interest and a case of information leakage or perhaps competition impact’.⁸⁹¹ Islamic countries, such as Malaysia, have resolved the question of independence with the establishment of a Central Sharia Committee, whose role is to add their approval of *Sharia* compliant products to that of individual financial institutions.⁸⁹² Other tactics that have been adopted by Islamic countries such as Pakistan include the requirement for an Islamic financial institution to only refer to one Islamic

⁸⁸⁶ *Ibid*

⁸⁸⁷ Foster, N.H.D., “Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts”, *Amicus Curiae Issue*, 68, 5, (2006): pp.1-7.

⁸⁸⁸ *Ibid*

⁸⁸⁹ Funds@work, “*The small world of Islamic finance – Sharia scholars and governance*”, (2011), <[http://www.funds-at-work.com/uploads/media/ShariaNetwork by Funds at Work AG.pdf_03.pdf](http://www.funds-at-work.com/uploads/media/ShariaNetwork_by_Funds_at_Work_AG.pdf_03.pdf)>

⁸⁹⁰ Casper, M., “Sharia boards and sharia compliance in the context of European corporate governance”, *Centrum fur Religion Und Moderne*, 8, 33, (2012): 15-33.

⁸⁹¹ Foster, N.H.D., “Encounters between legal systems: recent cases concerning Islamic commercial law in secular courts”, *Amicus Curiae Issue*, 68, 5, (2006): pp.1-7.

⁸⁹² Funds@work, “*The small world of Islamic finance – Sharia scholars and governance*”, (2011), <[http://www.funds-at-work.com/uploads/media/ShariaNetwork by Funds at Work AG.pdf_03.pdf](http://www.funds-at-work.com/uploads/media/ShariaNetwork_by_Funds_at_Work_AG.pdf_03.pdf)>

scholar for matters of *Sharia* compliance, and for that scholar to be prevented from serving in an advisory role on any other institution.⁸⁹³ One possible solution that has been suggested by Rehman is the establishment of a Central Sharia Committee within the UK, which would be responsible for paying the members of individual *Sharia* boards and for taking charge of the impartial allocation of scholars to *Sharia* Supervisory Boards.⁸⁹⁴ However, the likelihood that a Central Sharia Committee will be established in the UK in the near future is not significant, given the challenges that such an establishment is likely to present (particularly in terms of the difficulty of recruiting suitable scholars to such a board). The establishment of a Central Sharia Committee has also encountered opposition from those who argue that it would hinder competition and innovation among the Islamic financial industry. According to Casper, for example, the establishment of a Central Sharia Committee would remove the 5 per cent of cases in which there exists disagreement concerning the *Sharia* compliance of products and ‘that 5 per cent is very important for change and evolution in the industry’.⁸⁹⁵

7.2.5 The Risks Associated with Islamic Mortgages Offered by Non-Islamic Financial Institutions

The increase in the number of Islamic mortgages that are offered by non-Islamic financial institutions is associated with various risks that have had to be taken into consideration. A series of case studies conducted by Vayanos *et al* suggests that the key risk is associated with the need to establish effective liquidity and risk management techniques that are suitably tailored to the particular risk profiles of Islamic financial products.⁸⁹⁶ Specifically, the risk profiles that are associated with various Islamic home finance products differ significantly from the risk profiles of non-Islamic equivalents; in the case of a *Murabaha* transaction, for example, it is possible that the customer will not purchase a property despite having committed to do so.⁸⁹⁷ The risks that are associated with such products are arguably even greater due to the lack of standardisation within Islamic finance, and it is therefore necessary for non-Islamic financial institutions to

⁸⁹³ Casper, M., “Sharia boards and sharia compliance in the context of European corporate governance”, *Centrum fur Religion Und Moderne*, 8, 33, (2012): 15-33.

⁸⁹⁴ Rehman, S.S., “Globalisation of Islamic Finance Law”, *Wisconsin International Law Journal*, 25, 4, (2008): 1-35.

⁸⁹⁵ Casper, M., “Sharia boards and sharia compliance in the context of European corporate governance”, *Centrum fur Religion Und Moderne*, 8, 33, (2012): 15-33.

⁸⁹⁶ Vayanos, P., Wackerbeck, P., Golder, P., & Haimari, G., “*Competing successfully in Islamic Banking*”, (2014), <<http://www.strategyand.pwc.com/media/file/Competing-Successfull-Islamic-Banking.pdf>>

⁸⁹⁷ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

ensure that the necessary risk management techniques and capabilities are in place to manage those risks.⁸⁹⁸

Another risk that may be faced by non-Islamic financial institutions is associated with the possibility that they may not fully comply with *Sharia* principles for all of their Islamic mortgages. This risk is due to the absence of a universally harmonised system of *Sharia* standards, which has resulted in a plethora of different interpretations by different *Sharia* boards, a problem that is exacerbated by the lack of transparency concerning the way in which *Sharia* is applied.⁸⁹⁹ Consequently, non-Islamic financial institutions are faced with the necessity of ensuring consistent *Sharia* supervision, which, given the difficulty of hiring suitably qualified religious scholars, is likely to be problematic. This extends to the hiring of Islamic financial professionals in general, meaning that non-Islamic financial institutions face the risk that they will be unable to hire senior professionals with the necessary qualifications to oversee the management of their mortgage products.⁹⁰⁰

7.3 Sharjah Case Study

This section of the research project takes up the case study of Sharjah with specific regard to its mortgage laws and regulation, its housing sector and the financial crisis. Sharjah merged with 5 other Arab states to form the United Arab Emirates in 1971.⁹⁰¹ Whilst financial figures are generally available for each of the UAE states, they are often clubbed together as a unit for comparison with other countries.⁹⁰² The following table provides broad details about the UAE.

⁸⁹⁸ Ercanbrack, J., “The regulation of Islamic finance in the United Kingdom”, *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁸⁹⁹ Vayanos, P., Wackerbeck, P., Golder, P., & Haimari, G., “*Competing successfully in Islamic Banking*”, (2014), <<http://www.strategyand.pwc.com/media/file/Competing-Successfull-Islamic-Banking.pdf>>

⁹⁰⁰ Ercanbrack, J., “The regulation of Islamic finance in the United Kingdom”, *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

⁹⁰¹ Central Intelligence Agency, “*Factbook of United Arab Emirates*”, (2016), <<https://www.cia.gov/library/publications/the-world-factbook/geos/ae.html>>

⁹⁰² *Ibid*

Table 7: Important Details of United Arab Emirates

Location	Middle East, bordering the Gulf of Oman and the Persian Gulf, between Oman and Saudi Arabia
Area	83,600 sq. km
Natural Resources	Petroleum, natural gas
Population	5,927,482
Ethnic Groups	Emirati 19%, other Arab and Iranian 23%, South Asian 50%, other expatriates (includes Westerners and East Asians) 8%
Religions	Muslim (official) 76%, Christian 9%, other (primarily Hindu and Buddhist, less than 5% of the population consists of Parsi, Baha'i, Druze, Sikh, Ahmadi, Ismaili, Dawoodi Bohra Muslim, and Jewish) 15%
Median age	30.3 years
Population Growth Rate	2.47%
Urban Population	85.5% of total population
Major Urban Areas	Dubai 2.415 million; Sharjah 1.279 million; ABU DHABI (capital) 1.145 million
Literacy	Age 15 and over can read and write
GDP (PPP)	\$647.8 billion
GDP (Official Exchange Rate)	\$345.5 billion
GDP Per Capita	\$67,600
Industries	petroleum and petrochemicals; fishing, aluminium, cement, fertilizers, commercial ship repair, construction

	materials, handicrafts, textiles
Labour Force	5.136 million
Exports	\$323.8 billion
Imports	\$248.2 billion
Internet Users	5.274 million
Airports	43

As evident from the above information, the UAE has a per capita income that is practically on par with those of leading West European countries.⁹⁰³ Continuous and substantial oil revenues and a moderate approach towards foreign policy have helped the UAE in becoming an important player in regional affairs.⁹⁰⁴ The UAE states have however been adversely affected in recent years on account of the financial crisis of 2008-2009, the international banking crisis, falling real estate prices and the slump in prices of oil.⁹⁰⁵ The UAE has however avoided the unrest associated with the Arab Spring evidence elsewhere in the Middle East.⁹⁰⁶ The government has announced a multiyear billion USD infrastructure investment plan for the poorer emirates and is pursuing political reform.⁹⁰⁷

7.3.1 **The Impact of the Global Financial Crisis on the UAE**

The global financial crisis affected the North American, West European and Asia Pacific economies far more than others.⁹⁰⁸ GCC banks, whilst being adversely impacted by the crisis were better off than their counterparts in advance economies on account of their limited exposure to subprime assets and their continuing focus on traditional lending and savings mobilisation as well as their lower integration in global financial market.⁹⁰⁹ The impact of the financial crisis was transmitted to the GCC through the contraction in global economic activity, plunging asset

⁹⁰³ *Ibid*

⁹⁰⁴ *Ibid*

⁹⁰⁵ Khamis, M., “*The Impact of the Global Financial Crisis on the GCC Region: Lessons and Reform Priorities*”, (2010), < <https://www.oecd.org/mena/competitiveness/privatesectorinitiatives/46758795.pdf>>

⁹⁰⁶ *Ibid*

⁹⁰⁷ *Ibid*

⁹⁰⁸ Khamis, M., & Senhadji, A., “*Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead: An Update*”, (2010), < <https://www.imf.org/external/pubs/ft/dp/2010/dp1002.pdf>>

⁹⁰⁹ *Ibid*

prices and financial debt leveraging.⁹¹⁰The global crisis affected financial institutions and real estate developers with especial severity.⁹¹¹

Reduction in the flow of foreign investment into real estate came to an end in 2008 and put severe pressure on real estate construction firm, encouraging them to sell off.⁹¹² The end of real estate speculation resulted in sharp increase in mortgage default and financial distress for many listed commercial banks.⁹¹³ The GCC furthermore experienced significant stock price volatility. All GCC stock indices experienced sharp decline in the range of 40 to 60% in 2009.⁹¹⁴ Whilst these banks had limited exposure to international financial markets, they invested substantially in local firms and provided substantial funds to private firms for market investment.⁹¹⁵ Falling stock prices resulted in enhancement in number of loan defaults and asset value losses.⁹¹⁶ Oil was also used for transmission to the MENA countries. With the international downturn resulting in a sharp reduction in oil prices, OPEC members implemented a production cut for purposes of price stabilisation in 2009.⁹¹⁷

McKinsey stated that Islamic banks were not affected as much as conventional banks by the original effect of the global crisis; this probably reflected a more severe first round impact on conventional banks through security valuation into 2008.⁹¹⁸ H1 data for 2009 however indicated somewhat larger reductions in profitability of Islamic banks; this is felt to be a subsidiary consequence of the financial crisis on the real estate.⁹¹⁹ Islamic banks are ready to cope with other financial shocks because of their substantial liquidity and capital.⁹²⁰It needs to be kept in mind that sharia complainant financing encourages risk sharing, which in turn adds to resilience.⁹²¹

⁹¹⁰ *Ibid*

⁹¹¹ *Ibid*

⁹¹² Khamis, M., “*The Impact of the Global Financial Crisis on the GCC Region: Lessons and Reform Priorities*”, (2010), <<https://www.oecd.org/mena/competitiveness/privatesectorinitiatives/46758795.pdf>>

⁹¹³ *Ibid*

⁹¹⁴ *Ibid*

⁹¹⁵ Habibi, N., “*The Impact of the Global Economic Crisis on Arab Countries: A Year-End Assessment*”, (2009), <http://webcache.googleusercontent.com/search?q=cache:http://www.brandeis.edu/crown/publications/meb/MEB40.pdf&gws_rd=cr&ei=_KkZWPa-HInXvASRmL6wDQ>

⁹¹⁶ *Ibid*

⁹¹⁷ *Ibid*

⁹¹⁸ Jaber, H., “*Impact of the Global Financial Crisis on GCCUAE's Banking Sector*”, (2012), <<http://bspaace.buid.ac.ae/bitstream/1234/109/1/80108.pdf>>

⁹¹⁹ *Ibid*

⁹²⁰ *Ibid*

⁹²¹ *Ibid*

Islamic and conventional banks face risks that are comparable because (a) the risk profile of Sharia compliant and conventional financing agreements are similar and (b) the chief risk for both types of banks pertains to credit.⁹²² Islamic banks are nevertheless prohibited from assuming direct exposure to instruments of conventional banks.⁹²³ The difference in risk exposure of Islamic banks is thus concerned with their risk exposure to real estate, building and construction sectors, which is lesser than the average in Saudi Arabia.⁹²⁴ The following table provides details about important financial indicators of Islamic banks in Saudi Arabia and other countries in the Middle East.

⁹²²*Ibid*

⁹²³*Ibid*

⁹²⁴*Ibid*

Table 8: Important Financial Indicators of Islamic Banks in Saudi Arabia and other Countries in the Middle East⁹²⁵

	Saudi Arabia		Kuwait		U.A.E.		Bahrain		Qatar		GCC Average	
	Isl	All	Isl	All	Isl	All	Isl	All	Isl	All	Isl	All
CIR	22.1	16.0	21.7	16.0	12.8	13.3	24.5	18.1	17.9	15.6	19.8	15.7
CiP (2007/8)	2.0	-11.8	-42.7	-70.1	0.7	7.9	14.7	-4.8	4.5	21.7	-7.6	-14.2
CiP (H12007-H1-2008)	2.9	-11.9	-71.9	-65.3	-34.2	-19.5	-57.6	-36.8	0.0	5.1	-29.3	-23.3
CiP (2008 & H1-2009)	4.3	-7.2	-49.7	-65.8	-0.8	10.0	1.4	-3.4	2.8	25.4	-9.7	-10.5
RoA	3.7	2.1	1.6	3.2	1.7	2.2	2.6	1.3	6.6	2.6	3.2	2.3
Exp. to RE&C (as % total loans)	5.6	7.3	22.1	31.4	25.7	12.9	11.3	26.2	38.3	18.4	20.6	19.2

Key: CIR (Capital Inadequacy Ratio); CiP (Change in Profitability); RoA (Return on Assets); RE&C (Real Estate & Construction); Isl. (*Islamic*)

⁹²⁵*Ibid*, p 42

It is important to note that the profitability of all the banks in the GCC reduced in 2008 and 2009 for both Islamic and conventional banks. Islamic banks, nevertheless could face financial shocks better because of their greater capital and liquidity buffers.⁹²⁶ Sharia compliant contracts, with their focus on risk sharing augment this buffer because banks can pay off part of their losses by reducing their returns to their investors.⁹²⁷

Adam stated that the financial crisis has resulted in significant changes in approaches to corporate governance.⁹²⁸ The central bank of the UAE issued guidelines in 2010 and 2011, with regard to corporate governance.⁹²⁹

7.3.2 Mortgage Regulations in the UAE

The Central Bank of the UAE has issued a new set of regulation on mortgage lending to banks and other financial institutions.⁹³⁰ The contents are detailed below.

7.3.2.1 Aim of the UAE Mortgage Regulation

The regulation essentially defines the eligibility of diverse categories of borrowers on the basis of loan to property value ratios.⁹³¹ They state that the Central Bank wishes to ensure that banks, finance companies and other financial institutions that are engaged in the provisioning of mortgage lending to UAE nationals and expatriates do so in accordance with best practice and develop and implement control frameworks to moderate and guide their actions.⁹³² The regulation also applies without any exemption whatsoever to banks and financial institutions engaged in the provisioning of Sharia compliant funds for purchase acquisition.⁹³³ It thus seems

⁹²⁶ Adam, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

⁹²⁷ Khamis, M., & Senhadji, A., "Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead: An Update", (2010), < <https://www.imf.org/external/pubs/ft/dp/2010/dp1002.pdf>>

⁹²⁸ Adam, A., & Schuermann, T., "Understanding the Securitization of Subprime Mortgage Credit", *Federal Reserve Bank of New York Staff Reports* No. 318 (2008).

⁹²⁹ Khamis, M., & Senhadji, A., "Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead: An Update", (2010), < <https://www.imf.org/external/pubs/ft/dp/2010/dp1002.pdf>>

⁹³⁰ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

⁹³¹ *Ibid*

⁹³² *Ibid*

⁹³³ John, I., "UAE Central Bank issues new mortgage rules", (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

that central banks have regulated market borrowings by reducing leverage for borrowers and increase of owner's contribution in property investment.⁹³⁴

7.3.2.2 The Impact of the UAE Mortgage Regulation

The provisions of UAE mortgage regulations have been taken from the new mortgage rules of the UAE Central Bank and have been detailed below, precisely as they have been formulated to avoid mistakes in translation.

- The regulation states that in the case of UAE national properties valued at AED 5 million and below will require an LTV of a maximum of 80% of the value of the property.⁹³⁵
- The LTV shall be 70% of the property value where the property value is in excess of 5 million AED.⁹³⁶
- Each borrower will be entitled to seek only one loan for one property falling within these two categories.⁹³⁷
- It would thus appear that these LTV ratios are intended for owners who are also occupiers.⁹³⁸
- This is confirmed by the fact that UAE nationals who seek loan for a second home or investment property shall not be eligible for LTV in excess of 65% of the value of the property.⁹³⁹
- The central bank has also set specific limits for mortgage borrowing for non-UAE nationals.⁹⁴⁰
- This mortgage limit has been set at 75% of the value for properties that are valued at AED 5 million or less for the first property.⁹⁴¹

⁹³⁴ *Ibid*

⁹³⁵ Augustine, D.B., "New UAE mortgage regulations target property speculation". (2016), <

<http://gulfnews.com/business/sectors/banking/new-uae-mortgage-regulations-target-property-speculation-1.1248713> >

⁹³⁶ *Ibid*

⁹³⁷ *Ibid*

⁹³⁸ John, I., "UAE Central Bank issues new mortgage rules", (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

⁹³⁹ *Ibid*

⁹⁴⁰ *Ibid*

⁹⁴¹ *Ibid*

- If the value of the property exceeds AED 5 million, expatriate borrowers can borrow a maximum of 65% of the value of the property.⁹⁴²
- Each borrower is again limited to one loan for the purchase of properties within these categories.⁹⁴³
- Expatriates can borrow for second loan as well but the maximum loan available in such circumstances shall be restricted to 60% of the value of the property.⁹⁴⁴
- It has also been confirmed that GCC citizens would fall under the non-UAE national category and the regulations would apply accordingly.⁹⁴⁵
-

It has been confirmed that the above parameters shall be applicable only to properties that are completed. Different rules have been set for properties that are incomplete and thus purchased off plan.⁹⁴⁶ It has been stated that the maximum loan amount for the purchase of such properties, regardless of the buyer being a UAE or non-UAE national will be limited to 50% of the value of the property.⁹⁴⁷ This will hold good for first and second properties as well. The regulation furthermore informs that mortgage loans with deferred principal payment will be applicable only to investment loans.⁹⁴⁸ It should be seen that such loans do not allow for the non-payment of the principal for more than 5 years from the date of the first withdrawal of the loan.⁹⁴⁹ The following table provides an overview of the LTV ratios detailed above.

Information for this has again been taken from the UAE Central bank rules and has not been changed at all.

⁹⁴² *Ibid*

⁹⁴³ *Ibid*

⁹⁴⁴ *Ibid*

⁹⁴⁵ *Ibid*

⁹⁴⁶ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html> >

⁹⁴⁷ *Ibid*

⁹⁴⁸ *Ibid*

⁹⁴⁹ *Ibid*

Table 9: Overview of the LTV Ratios⁹⁵⁰

	UAE National	Non-UAE National
First Property (Built)	Property valued at AED 5 Million or less: LTV = 80%	Property valued at AED 5 Million or less: LTV = 75%
	Property valued at more than AED 5 Million: LTV = 70%	Property valued at more than AED 5 Million: LTV = 65%
Second or subsequent Properties (Built)	LTV = 65% (irrespective of value of property)	LTV = 60% (irrespective of value of property)
Property bought off plan	LTV = 50% (irrespective of value of property)	LTV = 50% (irrespective of value of property)

Mortgage providers are called upon to have a board approved list of independent valuers for the purpose of property valuation.⁹⁵¹ The valuer to be used in each case must be appropriately qualified, third party in nature and independent of the borrower, the seller, the developer, the contractor and others, for purposes of loan decision making.⁹⁵² The regulation states that the maximum term of a mortgage shall be 25 years and the maximum age limit of a borrower at the date of the last repayment due on the loan to be 70 for UAE nationals and 65 for non-UAE nationals.⁹⁵³ Mortgage providers must additionally have proper procedures and processes in place in order to ensure that accurate information on the incomes of borrowers is collected when

⁹⁵⁰ John, I., “UAE Central Bank issues new mortgage rules”, (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

⁹⁵¹ Augustine, D.B., “New UAE mortgage regulations target property speculation”. (2016), <

<http://gulfnews.com/business/sectors/banking/new-uae-mortgage-regulations-target-property-speculation-1.1248713> >

⁹⁵² *Ibid*

⁹⁵³ *Ibid*

determining payment ability.⁹⁵⁴ Loan providers must develop standard debt burden ratio calculation template for this purpose. The debt burden ratio cannot exceed 50%.⁹⁵⁵ The maximum financing allows for UAE national has been set at 8 times for UAE nationals and at 7 times for non-UAE nationals.⁹⁵⁶ The calculation of the DBR is furthermore disregarding any introductory or promotional interest rate being offered by the lender.⁹⁵⁷

7.3.3 Laws Regarding Islamic Banks, Financial Institution and Investment Companies in the UAE

The laws governing Islamic banking and financing in the UAE is provided below.

These have been reproduced, as they have been framed in order to avoid errors and misinterpretations in translation and paraphrasing.

Table 10: Islamic Banking and Financing Law in the UAE⁹⁵⁸

Article No	Details
1.	<ul style="list-style-type: none"> • Islamic Banks, financial establishments and Investment companies means these whose Articles of Association or bylaws comprise an obligation to the enforcement of the provisions of the Islamic Sharia and who carry out their activities pursuant to these provisions.
2.	<ul style="list-style-type: none"> • Islamic Banks, financial establishments and investment companies shall be set up in the State and shall exercise their activities in compliance with the provisions of this Law. • These banks, establishments and companies shall be subject to Federal Law no. 10 of 1980 2 and Federal Law no. 8 of 1984 above mentioned and to other Laws and regulations in force in the State and to the

⁹⁵⁴ *Ibid*

⁹⁵⁵ *Ibid*

⁹⁵⁶ *Ibid*

⁹⁵⁷ *Ibid*

⁹⁵⁸ Sohbetna.com, “Federal Law No. 6 "On Islamic Banks, Financial Establishments and Investment Companies”, (2009), <<http://www.sohbetna.com/business/uaelaw/federallawno6onislamicbanksfinancialestablishments/>>

	<p>common customary rules – regarding all matters not governed by a special text in this Law.</p> <ul style="list-style-type: none"> • These banks, establishments and companies shall be in the form of General Joint Stock Companies and shall be set up pursuant to the provisions provided for in Federal Law No. 8 of 1984 above mentioned, and shall be subject to the Central Bank licensing, control and inquisition in compliance with Federal Law no. 10 of 1980 2 above mentioned and not contradicting the provisions of this Law. • The provisions of the preceding paragraphs, except for whatever is related to the setting up and the form – shall apply to the branches and offices established in the State by the foreign Islamic banks, financial establishments and Investment companies.
3.	<ul style="list-style-type: none"> • Islamic banks shall have the right to carry out all or some of the banking, commercial, financial and investment services and transactions. They are also entitled to carry out all kinds of services and transactions performed by the banks provided for in Federal Law no. 10 of 1980 2 above mentioned without restricting to the periods mentioned therein whether these services or transactions are carried out to the account of or in participation with the Islamic Bank, or third parties. The Islamic banks are also entitled to set up companies and contribute in existing or under - construction projects on condition that their activities are consistent with the provisions of the Islamic Sharia. • Islamic Financial Establishments and Investment Companies are entitled to carry out credit and lending transactions and other financial transactions, contribute in existing or under - construction projects, invest their funds in movable values and receive cash deposit for their investment in compliance with the provisions of the Islamic Sharia.
4.	<ul style="list-style-type: none"> • Islamic Banks, Financial Establishments and Investment Companies set up in the State, and the branches and offices of the foreign Islamic banks, financial establishments and investment companies licensed to operate inside the State shall be excluded from the provisions of

	<p>paragraph A of Article 90 and paragraph E of Article 96 of Federal Law no. 10 of 1980 above mentioned.</p> <ul style="list-style-type: none"> • These parties shall be excluded from the provisions of paragraph B of Article 90 of Federal Law no. 10 of 1980 above mentioned not in contradiction with the provisions of the legislations in force in the concerned Emirate.
5.	<ul style="list-style-type: none"> • A Higher Sharia organisation shall be set up by a decision from the Council of Ministers and shall be composed of Sharia, legal and banking individuals. It shall be entrusted with the higher control on Islamic banks, financial establishments and Investment companies to verify from the legality of their transactions pursuant to the provisions of the Islamic Sharia and to render its opinion in the matters submitted to these parties during exercising their activities. The opinion of the higher organisation shall be obligating to the mentioned parties. This organisation shall be attached to the Ministry of Islamic Affairs and Endowments.
6.	<ul style="list-style-type: none"> • The Articles of Association of the Islamic bank, financial establishment or the investment company and their bylaws must indicate the establishment of the Organization of Al - Sharia control composed of at least three members which shall be entrusted with conforming their transactions and acts to the provisions and rules of the Islamic Sharia. The bylaw of each of them must specify the method for the establishment of this organisation and the mode of carrying out its activity and its other authorities. The names of the Sharia Control Organisation shall be submitted to the higher Organisation provided for in the preceding Article for authorisation before the issuance of the establishment decision.
7.	<ul style="list-style-type: none"> • In case the Islamic bank, financial establishment or investment company are subject to the control of the State Audit Institution in compliance with Federal Law no. 7 of 1976 above mentioned, the task of the audit Institution shall be limited to the subsequent control, and

	the audit Institution must not interfere in operating the activities of these parties or intrude upon to their policy.
8.	<ul style="list-style-type: none"> Islamic Banks, Financial Establishments and Investment Companies and the branches and offices of the foreign Islamic banks, financial establishments and investment companies existing at time of implementing this Law are required to adjust their situations pursuant to its provisions within one year from the date of their enforcement.
9.	<ul style="list-style-type: none"> The competent Ministers and authorities in the Emirates – each within his concern – are required to implement the provisions of this Law.
10.	<ul style="list-style-type: none"> This Law shall be published in the Official Gazette and shall come into force as of its publication date.

Islamic financing and the relevant laws of the UAE as has been discussed earlier, have grown over the years and has now become an important element of financing in the UAE as well as an important contender to conventional financing. Whilst the Islamic financing sector is still in its infancy, compared to the established conventional banking system, various barriers and tumbling blocks on the structuring of the Islamic financing product are being steadily removed in order to make them competitive with their counterparts in the world of conventional banking.⁹⁵⁹ Visser stated that Islamic financing is governed by the Sharia, an abstract form of law that has been derived from Islamic principles and can be adapted, developed and interpreted further.⁹⁶⁰ It is important to note that the Sharia is not a codified law in the UAE.⁹⁶¹ It does not prescribe general legal principles but aims to deal with specific transactions and formulated rules that govern them.⁹⁶² Islam has constantly focused on the establishment of justice, the elimination of exploitation in business transactions, the elimination of all types of unjustified enrichment and the cessation of dealing in transactions that are speculative or excessively risky.⁹⁶³ Islamic scholars have accordingly deduced three principles from the Sharia but formed the foundation of

⁹⁵⁹ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁹⁶⁰ Visser, H., *Islamic finance: principles and practice*, (London: Routledge Publishers, 2013).

⁹⁶¹ Gill, R., “THE NEW UAE MORTGAGE REGULATIONS”, (2014), p 1, < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

⁹⁶² Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁹⁶³ *Ibid*

Islamic economics and differentiate it from conventional banking and financing.⁹⁶⁴ These three differentiating factors comprise (1) the prohibition of interest, (2) the sharing of both profits and losses and (3) the elimination of uncertainty and excessive speculation in normal business transactions.⁹⁶⁵ The UAE is governed by a civil law system, which implies that all underlying commercial and banking laws have been codified.⁹⁶⁶ Separate legislation for the codification of Sharia law for commercial transactions within the UAE does not exist at present.⁹⁶⁷ The UAE also does not have Sharia courts that can attend to disputes stemming from or related to Sharia financing transactions.⁹⁶⁸ It is however important to keep in mind that several facets of sharia rules have been included in civil law.⁹⁶⁹ It can thus be concluded that a substantial element of UAE commercial legislation is in tandem with Sharia tenets. UAE courts can furthermore consult the Sharia when legislation and business practices on specific issues that are not clear. The UAE Federal law No. 5 of 1985, which concern the civil code and the Federal Law No. 18 of 1993, which is concerned with the commercial code lays down the main provisions for the UAE civil and commercial transactions.⁹⁷⁰

Gill stated that the primary challenge in the structuring and offering of Islamic complaint products in the UAE involves the bridging of occasional gaps and mismatches between Sharia principles and UAE laws.⁹⁷¹ The provisions of UAE laws have, it should be noted been found to be inconsistent with Sharia principles in certain areas.⁹⁷² The charging of interest, for example is by and large allowed under UAE legislation subject to the fact that it is not overly excessive. Interest however is absolutely prohibited under Sharia regardless of the amount. It also needs to be noted that dealing with the entertainment industry and pork is not illegal in the UAE, whilst it is absolutely prohibited by the Sharia.⁹⁷³ John stated that these restrictions and prohibitions should be eliminated from the financing structure and removed from agreement, wherever

⁹⁶⁴ *Ibid*

⁹⁶⁵ *Ibid*

⁹⁶⁶ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

⁹⁶⁷ *Ibid*

⁹⁶⁸ *Ibid*

⁹⁶⁹ *Ibid*

⁹⁷⁰ Sohbetna.com, "Federal Law No. 6 "On Islamic Banks, Financial Establishments and Investment Companies", (2009), <<http://www.sohbetna.com/business/uaelaw/federallawno6onislamicbanksfinancialestablishments/>>

⁹⁷¹ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

⁹⁷² *Ibid*

⁹⁷³ *Ibid*

possible in order to achieve Sharia compliance.⁹⁷⁴ Banking experts are however somewhat apprehensive about transactions that fall in grey areas, i.e. customary practice offers the guidance and UAE laws are silent on the issue. One example of such an area is that of derivatives transactions.⁹⁷⁵ Perceived from Sharia angle, the uncertain and speculative nature of derivative transactions should normally be contrary to Sharia provisions.⁹⁷⁶ UAE laws are however silent on this issue and customary guidance on the same is not available from market practice.⁹⁷⁷ With the courts being allowed to refer issues to the Sharia in the absence of specific legislation and established customary business practices, it can be assumed that they will approach the Sharia when required for assessing the legality of derivatives transactions.⁹⁷⁸

Wilson stated that it was standard practice for a Sharia product to be structured and certified by Sharia scholars or experts as Sharia compliant.⁹⁷⁹ It can as such be assumed a product that is offered to the public by a licensed financial institution in the UAE has undergone legal and Sharia analysis before it is made available to the public.⁹⁸⁰ It should however be kept in mind that whilst such announcements result in formalising of approval from Sharia perspectives, their effect is not legally or commercially binding and UAE courts are not mandated to take Sharia pronouncements into account during the hearing of a case; it would be the practice in such cases to depend upon the terms of the contract in the formulation of a judgement.⁹⁸¹ John stated that if a dispute was brought to a UAE court, it would be unlikely to the court to apply a different treatment to the issue just because of the transaction being compliant with Sharia.⁹⁸² The disputes in such circumstances are likely to be subject to the same processes and procedures as a conventional contract.⁹⁸³ The courts are likely to apply UAE laws in deciding upon such cases. If a document appears to be governed by Sharia law, the court will in all probability disregard such choice of law and apply suitable UAE legislation.⁹⁸⁴

⁹⁷⁴ John, I., “UAE Central Bank issues new mortgage rules”, (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

⁹⁷⁵ *Ibid*

⁹⁷⁶ *Ibid*

⁹⁷⁷ *Ibid*

⁹⁷⁸ *Ibid*

⁹⁷⁹ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

⁹⁸⁰ Augustine, D.B., “New UAE mortgage regulations target property speculation”. (2016), < <http://gulfnews.com/business/sectors/banking/new-uae-mortgage-regulations-target-property-speculation-1.1248713> >

⁹⁸¹ *Ibid*

⁹⁸² John, I., “UAE Central Bank issues new mortgage rules”, (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

⁹⁸³ Sohbetna.com, “Federal Law No. 6 "On Islamic Banks, Financial Establishments and Investment Companies”, (2009), <<http://www.sohbetna.com/business/uaelaw/federallawno6onislamicbanksfinancialestablishments/>>

⁹⁸⁴ *Ibid*

Al Tamimi and Company stated that it was prudent in such cases, especially from the perspective of the legal enforceability of an agreement for the elements required for Sharia compliant is being contractually included within the body of the agreement.⁹⁸⁵ Islamic financial institutions within the UAE provide several types of mainstream products, like the Ijarah, Murabaha, Mudaraba and Ististna.⁹⁸⁶ It is interesting to note that these are fully supported, from the perspectives of both loans and deposits by support services like the provisioning of cheque books, Internet banking and credit cards that are compliant with Sharia tenets.⁹⁸⁷ Sharia requires that all Sharia structures must essentially comply with the laws of the jurisdiction in which they are made available to clients.⁹⁸⁸ Certain products, especially those which involve beneficial ownership or trust arrangements are not offered in the UAE because they are structures were incompatible with local laws.⁹⁸⁹ It can as such be generally surmised that the civil code of the UAE has its strong Sharia foundation, which in turn assists the suitable regulation of Islamic financial mechanisms.⁹⁹⁰ Certain mismatches between Sharia principles and UAE laws however do exist that are quite minimal when compared with other important financial jurisdictions.⁹⁹¹

7.3.4 Theoretical Model of Mortgages and Securitisation as Applied to Sharjah laws, Legal Cases and Processes

Sabarwal stated that financial service in Islamic banking is different from conventional banks.⁹⁹² With interest being prohibited, questions have been raised about the possibility of securitising financial services of Islamic banks from the perspective of jurisprudence.⁹⁹³ It is also necessary in such circumstances to investigate which of these services can be securitised to facilitate the trading of instruments in both primary and secondary markets.⁹⁹⁴ Several of the products and services offered by Islamic banks can be adopted for securitisation.⁹⁹⁵ There was

⁹⁸⁵ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <
<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

⁹⁸⁶ *Ibid*

⁹⁸⁷ *Ibid*

⁹⁸⁸ *Ibid*

⁹⁸⁹ *Ibid*

⁹⁹⁰ *Ibid*

⁹⁹¹ *Ibid*

⁹⁹² Sabarwal, S., *Common Structures of Asset-Backed Securities and Their Risks*, (Washington: Washington University, 2005).

⁹⁹³ *Ibid*

⁹⁹⁴ *Ibid*

⁹⁹⁵ *Ibid*

little doubt that Murabaha features were different from others and the process could be used for the same purpose.⁹⁹⁶ Some of these differentiating aspects are highlighted below.

- Clear income, suitable for risk-averse investors.
- Low risk of default.
- Particular timing.
- Suitability for diverse markets.⁹⁹⁷

7.3.5 **Murabaha Mortgage Securitisation**

The bank, which has provided its resources to the government, institutions and households through Murabaha contracts and has obtained mortgages against them, can replenish their resources by securitising the claims of Murabaha services.⁹⁹⁸ The concerned banks should in such circumstances establish special purpose vehicles, wherein these SPVs gather the cash of investors by issuing Murabaha securities and the agent of investors can buy the claims of Murabaha services with discounts from the bank.⁹⁹⁹

The bank furthermore undertakes to collect the nominal value of claims from debtors in definite maturities and provide them to security holders through investment banks.¹⁰⁰⁰ Security holders (investors) can wait till maturity and get the benefit of securities interest or sell their securities in the secondary market.¹⁰⁰¹ The following charts provide details about the practical model of Murabaha securities in the primary and secondary market. The diagram detailed below taken from Mousavian *et al.*, (2008) illustrates the process of securitisation of Murabaha services.

⁹⁹⁶*Ibid*

⁹⁹⁷*Ibid*

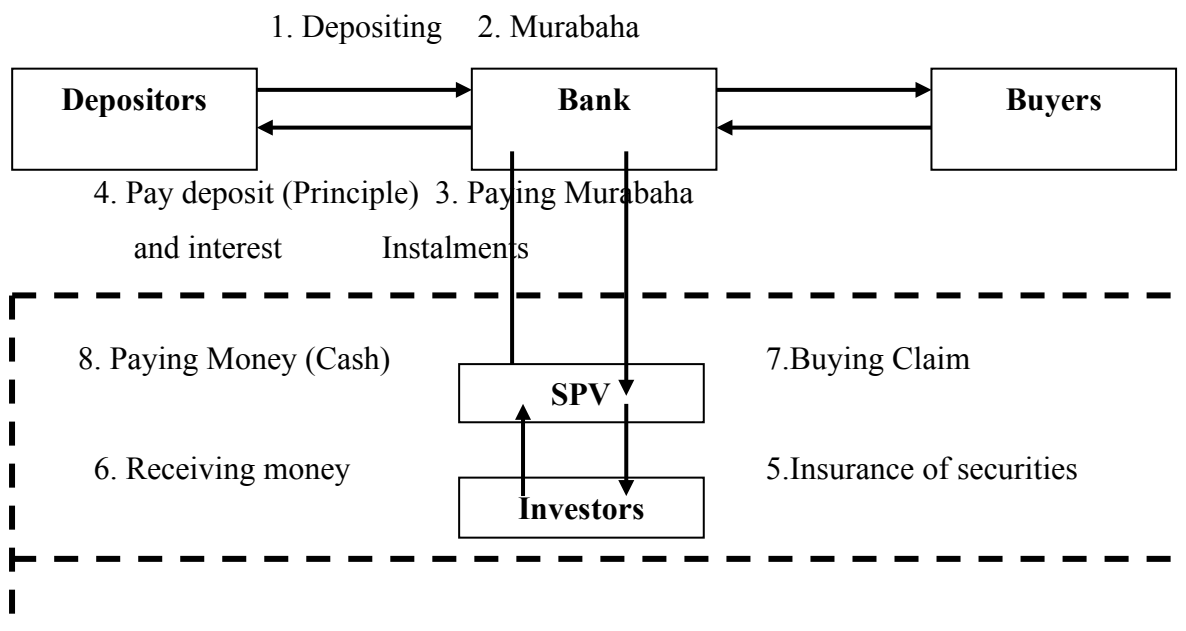
⁹⁹⁸ Mousavian, S.A., Vosough, B., & Arani, F.A., "Murabaha Mortgage Backed Securities - A New Financial Instrument for Islamic Banking", (2008), <<http://conference.qfis.edu.qa/app/media/274>>

⁹⁹⁹*Ibid*

¹⁰⁰⁰*Ibid*

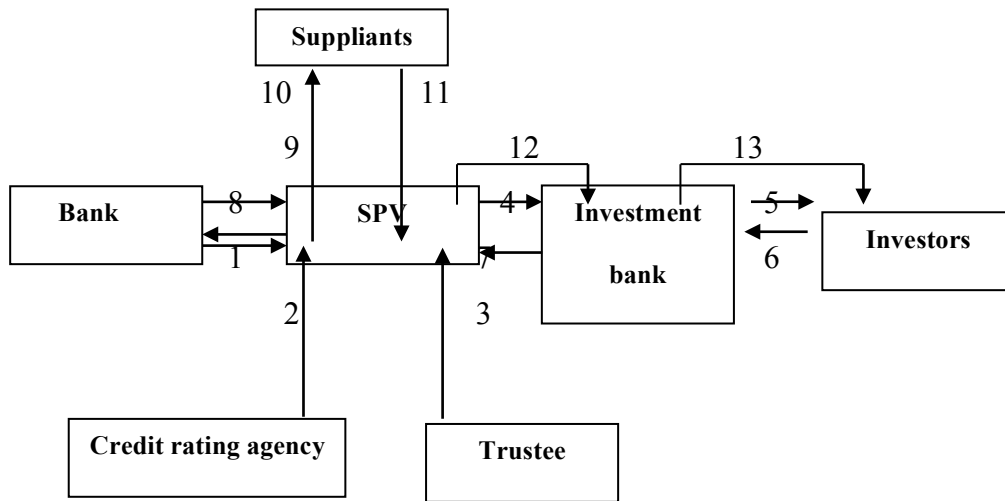
¹⁰⁰¹*Ibid*

Chart 7: The process of securitizing Murabaha Services¹⁰⁰²



¹⁰⁰² *Ibid*, p 11

Chart 8: The Process of Securitizing Murabaha¹⁰⁰³



The legal dimension of Murabaha Mortgage backed securities is detailed below.¹⁰⁰⁴

1. The bank, by choosing or creating the SPV proclaims its readiness for giving claims on Murabaha mortgage backed securities on a specific discount rate.
2. The SPV, by choosing a credit rating agency that is confirmed by the Central Bank and the securities and exchange organisation attempts to obtain its credit grade, which should be announced by the credit rating agency.
3. The Special Purpose Vehicle, by choosing an investment bank that is confirmed by the Central Bank and the Securities and Exchange Organisation attempts to monitor the plan; the investment bank should agree to monitor the plan from the beginning to the end.
- 4 & 5. The SPV offers the issued Murabaha mortgage backed securities through the investment bank to a wide variety of investors.
- 6 & 7. The investment bank collects money from investors and gives it to the SPV.
- 8, 9 & 10. The SPV can use the money collected from the people, can by purchase the claims of Murabaha mortgage services at a discount and obtain ownership of the claims, as the agents of the security holders.

¹⁰⁰³*Ibid*, p 12

¹⁰⁰⁴*Ibid*

11, 12 & 13. The special purpose vehicles can obtain the claims of Murabaha mortgage services in particular maturities; they can obtain their rightful dues and provide the balance to the people through the investment bank.

7.3.6 Secondary Market of Murabaha Mortgages

Murabaha mortgage backed securities can be considered to be beneficiary financial instruments with specific interest; they should thus be attractive for investors who wish to have low risk investments and thus should be capable of being traded in the secondary market. In the absence of juridical problems, the holders of Murabaha mortgage backed securities can be considered to be owners of financial notes with precise maturity dates; their owners can make use of customised discount rates to sell them at prices lesser than nominal values to third parties.¹⁰⁰⁵

7.3.7 Juridical Qualification of Murabaha Mortgage Backed Securities

Murabaha securities can be sold through both primary and secondary markets.¹⁰⁰⁶ A bank can use cash from investor resources to purchase goods from suppliers and sell them as credit.¹⁰⁰⁷ A specific purpose vehicle can accumulate monies, purchase Murabaha claims on behalf of security holders, who can wait till the date of maturity or dispose of them in the secondary market.¹⁰⁰⁸

7.4 Saudi Case Study

7.4.1 Introduction

This chapter takes up the study of Islamic finance, with particular regard to mortgaging of home property in the Kingdom of Saudi Arabia. Saudi Arabia has recently brought in new laws to stimulate and encourage mortgaging activity in the country. Apart from providing details about the new laws, the chapter also details the Sharia implications of mortgage based transactions and the likely impact of the new laws on Islamic finance in the country.

¹⁰⁰⁵ *Ibid*

¹⁰⁰⁶ *Ibid*

¹⁰⁰⁷ *Ibid*

¹⁰⁰⁸ *Ibid*

7.4.2 Saudi Mortgage Law

Saudi Arabia is making significant steps towards the creation of a mortgage industry and is opening up to finance providers. Saudi banks have strong balance sheets and extensive reach.¹⁰⁰⁹ These advantages give them an upper hand in the mortgage business over private finance companies.¹⁰¹⁰ The key features of the new laws, namely the Real Estate Finance Law, Supervision of Finance Companies Law, the Finance Lease Law, the Real Estate Mortgage Law and the Enforcement law is provided below.

7.4.3 Table 11: Key Features of the New Law¹⁰¹¹

These key features have been replicated from information provided by Saudi publications in order to avoid errors in translation.

Major Laws	Coverage	Status	Key Provisions
Real Estate Finance Law	Regulation of real estate finance companies	Final Draft	<ul style="list-style-type: none"> Commercial banks and finance companies (REF) will be licensed by SAMA to provide real estate finance. Creation of an entity for mortgage refinancing called “Real Estate Refinancing Corporation” (RERC) with a minimum capital of SAR5bn, in which the PIF will pick up a stake and which may publicly list a part of its shares. REFs will also be allowed to have a stake

¹⁰⁰⁹ Oxford Business Group, “Saudi Arabia's new mortgage law”, (2016), <<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁰¹⁰ *Ibid*

¹⁰¹¹ Al Rajhi Capital, “Saudi Mortgage law: Planning for the long-term”, (2013), <http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

			<p>(combined ceiling of 3 0%) after five years.</p> <ul style="list-style-type: none"> • RERC will help create a secondary mortgage market by buying and selling mortgages. • Banks will be able to own real estate properties for real estate finance purposes. • REFs to be granted access to courts' and notaries' registers.] • Borrowers are required to have a credit record with the Saudi credit bureau - SIMAH.
Supervision of Finance Companies Law	Regulation of finance companies	Final Draft	<ul style="list-style-type: none"> • REFs will be licensed by SAMA. • REFs will be required to list a percentage of capital through an IPO after two fiscal years, subject to a certain level of revenue being achieved. • The minimum capital required to form a REF will range from SAR10mn to SAR500mn, depending on the scope of the business
Finance Lease Law	Regulation of finance leasing companies	Final Draft	<ul style="list-style-type: none"> • SAMA to license companies to carry out finance leasing business in the country. • Formal requirements of the finance lease, including registration, have been finalised. • Issuance of securities backed by lessor rights, subject to rules and regulations under Capital Market Authority.
Real Estate	Regulation to	Under	<ul style="list-style-type: none"> • Mortgage to be registered in accordance

Mortgage Law	recognise mortgages (including mortgage registration)	Review	<p>with the real estate registration law. A mortgage will be effective from the time of registration.</p> <ul style="list-style-type: none"> • REFs to have certain unprecedented rights such as: <ol style="list-style-type: none"> 1. Second ranking and successive mortgages to be allowed. 2. In case of division of the title deed, mortgagee to have the right to attach the divided property. 3. Right to have priority over other unsecured creditors.
Enforcement Law	Authority for enforcement	Under Review	<ul style="list-style-type: none"> • Creation of dedicated enforcement judges (Qadi Al Tanfiz) to hear enforcement disputes and insolvency cases as well as order enforcement of judgments. • The judges will apply the Sharia principles and their decision will be final, subject to a right of appeal in respect of judgments on enforcement disputes and insolvency actions.

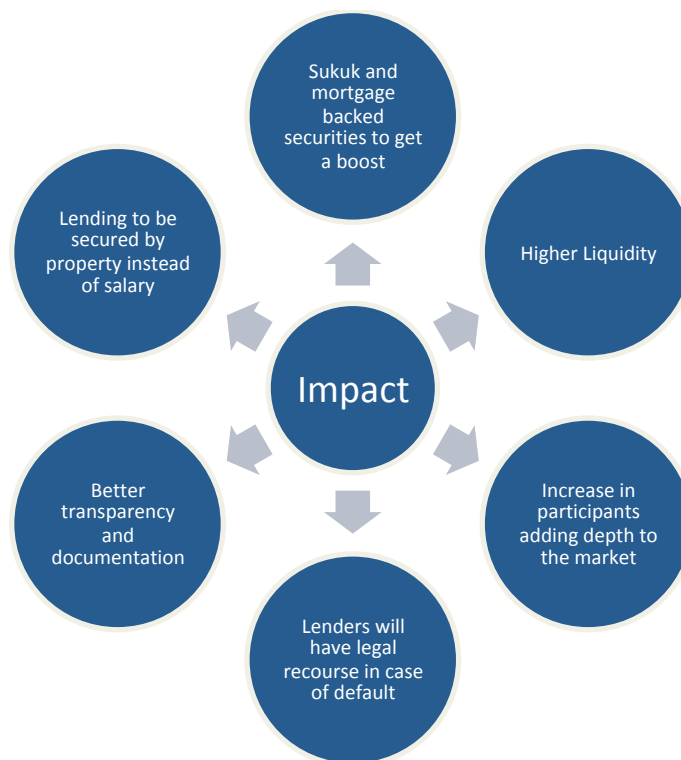
7.4.4 **Table 12: Beneficiaries Under the New Law**¹⁰¹²

Banks & FI's	<ul style="list-style-type: none"> • Opening up of an entirely new mortgage and securitisation market • Development of a long-term Sukuk market • Government support in the form of loans/long term deposits to avoid funding mismatch
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¹⁰¹²*Ibid*

	<ul style="list-style-type: none"> • More liquidity through refinancing • Permission to own residential real estate thereby eliminating any middle-men
Real Estate Developers	<ul style="list-style-type: none"> • More transparency and documentation • New lending requirements will envisage standardization of property features and the construction process • Allow developers to streamline their construction schedules • More cooperation and liquidity from banks means developers can reduce turnaround time for construction
Investors	<ul style="list-style-type: none"> • Clarity on the property market as more real estate data is made public • Efficient allocation of funds and generation of maximum returns on investments • Listing of real estate finance companies will ensure better transparency and disclosures • New investment avenue will emerge in the form of mortgage backed securities
Government	<ul style="list-style-type: none"> • Formulate better policies to regulate and develop the sector • Regulatory and enforcement mechanisms will gradually evolve and be comparable to those of the developed markets • Enable the government to get rid of wasteful expenditure on inefficient subsidies and disbursal mechanisms
Consumers	<ul style="list-style-type: none"> • Supply of housing units will increase and satiate unmet demand • Higher liquidity in the system will lead to faster approval of housing • Age group in the range of 30-45 will have a better chance to obtain finance • Those with a salary level of SAR25,000 onwards will be able to afford a high-end accommodation (e.g. Villa)

7.4.5 **Chart 9: Likely Impact of the New Law**¹⁰¹³



The new finance laws in Saudi Arabia provide a legal structure for mortgage registration, foreclosure and regulation of financing organisations, including those with active operations in real estate.¹⁰¹⁴ It is expected that these enactments lead to an overhaul of the Kingdom’s home finance market, with features that range from the registering of mortgages to enabling judges to prosecute police officers who fail to carry out eviction orders.¹⁰¹⁵ Whilst these changes should result in enhancement of residential lending to approximately 32 billion USD every year, it is expected that they will result in the creation of licensed private mortgage providers as well as state run companies.¹⁰¹⁶

The new laws should help in the creation and registration of real estate mortgages.¹⁰¹⁷ Lenders of funds will be able to take on foreclosures, which will be a drastic improvement on the

¹⁰¹³ *Ibid*

¹⁰¹⁴ Oxford Business Group, “Saudi Arabia’s new mortgage law”, (2016), <<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁰¹⁵ *Ibid*

¹⁰¹⁶ *Ibid*

¹⁰¹⁷ Deloitte, “Saudi mortgage laws A formula for a well functioning market?”, (2013), <https://www2.deloitte.com/content/dam/Deloitte/xc/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

earlier situation when legal reprieves were available.¹⁰¹⁸ Better documentation should help in clarifying title deeds, which will help the real estate market to achieve long term development. Several new real estate finance companies should be attracted to the market.¹⁰¹⁹ A regulated market should again induce the development of secondary markets through refinancing, resulting in the gradual introduction of mortgage backed securities in the kingdom.¹⁰²⁰ The possible emergence of a long term Sukuk market should result in creation of greater liquidity in the market and the development of a long term yield curve.¹⁰²¹ Good opportunities should open up for principal stakeholders; substantial new opportunities should open up for banks.¹⁰²² Real estate developers should benefit from greater liquidity and achieve lower turnaround time for construction.¹⁰²³ Investors should benefit from greater clarity in the property market as increasing amounts of real estate data is progressively made public.¹⁰²⁴ The actual listing of real estate finance companies will result in better disclosures and transparency; it is expected that a regulatory mechanism comparable with the best in the world would evolve progressively, lowering the demand on the government to provide inefficient subsidies and maintain disbursal mechanisms.¹⁰²⁵ The consumers should also benefit from increased supply, which shall be created to meet the growing demand.¹⁰²⁶

It is however important to keep in mind that the new law does not motivate land owners or developers to utilise undeveloped land.¹⁰²⁷ The absence of a clear legal framework, closely connected to foreclosure has until now resulted in restricted lending.¹⁰²⁸ Mortgage penetration rates in Saudi are low at 5%, compared to 5 to 10% in the neighbouring countries.¹⁰²⁹ Ali stated that Saudi banks currently utilise diverse financing strategies, which make use of the Ijara on account of the absence of mortgage laws.¹⁰³⁰ The introduction of the new laws will help in enhancement of Islamic financing, particularly Murabaha, in the area of mortgages; such a

¹⁰¹⁸ *Ibid*

¹⁰¹⁹ *Ibid*

¹⁰²⁰ *Ibid*

¹⁰²¹ *Ibid*

¹⁰²² *Ibid*

¹⁰²³ *Ibid*

¹⁰²⁴ *Ibid*

¹⁰²⁵ *Ibid*

¹⁰²⁶ *Ibid*

¹⁰²⁷ Oxford Business Group, “*Saudi Arabia's new mortgage law*”, (2016),

<<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁰²⁸ *Ibid*

¹⁰²⁹ *Ibid*

¹⁰³⁰ Ali, J.I., “*Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws*”, (2013), <

http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

method would let the buyer keep asset ownership.¹⁰³¹ Such legislation will also help people in buying more homes.¹⁰³²

Deloitte stated that the new law does not incentivise land owners or developers to utilise undeveloped lands.¹⁰³³ The absence of a clear legal framework, with particular regard to foreclosure has resulted in restricted lending and mortgage penetration rate in Saudi Arabia are low than the neighbouring GCC countries.¹⁰³⁴ Whilst the mortgage penetration rate in Saudi Arabia is 2%, it is about 5% in the neighbouring GCC countries and more than 70% in developed countries like the UK and the USA.¹⁰³⁵ The new law does not explicitly state mortgage or finance companies will have the right for foreclosure by taking outright ownership of the property in case of the insolvency of the applicant.¹⁰³⁶ The additionally judgement given by the judges under the Sharia law do not set a binding precedent and similar defaults in mortgage payments could result in different verdict.¹⁰³⁷ There also does not appear to be any guarantee of standardisation in pricing of mortgage products in the absence of a long term yield curve.¹⁰³⁸ The health of the borrower is also an important criterion for lending as it is impossible to evict the dependence of a borrower and the debt is usually waived of in case of debt.¹⁰³⁹

7.4.6 Sharia Implications of Mortgage Based Transaction

This section deals with the Sharia implications for the diminishing Musharaka. The Sharia has categorically prohibited Riba and Gharar is prohibited on a case to case basis.¹⁰⁴⁰ Bankers have the freedom to develop financial instruments that are convenient to satisfy their various needs of the Islamic community keeping in view these two prohibitions.¹⁰⁴¹ The diminishing Musharaka is a new finance technique, which ends in the transfer of ownership to one party, i.e. the entrepreneur.¹⁰⁴² An Islamic bank and an entrepreneur can make use of this tool to develop a

¹⁰³¹ *Ibid*

¹⁰³² *Ibid*

¹⁰³³ Deloitte, “*Saudi mortgage laws A formula for a well functioning market?*”, (2013), <https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹⁰³⁴ *Ibid*

¹⁰³⁵ *Ibid*

¹⁰³⁶ *Ibid*

¹⁰³⁷ Ali, J.I., “*Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws*”, (2013), <

http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹⁰³⁸ *Ibid*

¹⁰³⁹ *Ibid*

¹⁰⁴⁰ Iqbal, M., & Molyneux, P., *Thirty Year of Islamic Banking: History, Performance and Prospects*, (Palgrave Macmillan: NY, 2004).

¹⁰⁴¹ *Ibid*

¹⁰⁴² *Ibid*

joint project that could ultimately lead to sole ownership of the entrepreneur.¹⁰⁴³ Profits and losses in such a contract are shared according to the Musharaka principles.¹⁰⁴⁴ A certain proportion of the entrepreneur's share in profits is kept in escrow account.¹⁰⁴⁵ As soon as the value of the account becomes equivalent to the value of the financier ownership in the joint enterprise, the payment for this ownership is made and the entrepreneur becomes the sole owner.¹⁰⁴⁶ This method has been discussed and approved as a permissible mode of financing at the First International Conference on Islamic Banking in 1979.¹⁰⁴⁷

The concept of developing an Islamic version of the traditional concept of preferred stock was taken up for discussion at the conference as the first priority but a task force recommended the diminishing Musharaka as the sole suitable mode of financing.¹⁰⁴⁸ This consideration was based upon the peculiar legal position of the *Waqf* properties, namely that a financier cannot keep permanent ownership in a *Waqf* property, which is basically a separate legal entity.¹⁰⁴⁹ The task force appointed for this purpose by the Islamic conference suggested that the *Waqf*, in its capacity as a legal entity with participation of its properties and an Islamic bank, working as a financier can develop a profit sharing joint project.¹⁰⁵⁰ The ownership of the bank will in such circumstances be liquidated in favour of the enterprise in its specified period of time and the whole *Waqf* ownership will be completely returned.¹⁰⁵¹ The Sudan Islamic Bank utilises, in the case of a diminishing Musharaka a formula of diminishing ownership, whereby the partner client becomes the sole owner at the time of liquidation.¹⁰⁵² The SIB negotiates the basis of participation upon the approval of the application, determines the specific contribution by the different partners and finalises the industrial operation of the firm. SIB will subsequently be involved in the Musharaka in its working capital as well.¹⁰⁵³ A contract shall subsequently be signed detailing the main features of the partnership and the respective contributions and shares of partners.¹⁰⁵⁴ The partner client will also undertake to allocate a proportion of its annual profits

¹⁰⁴³ *Ibid*

¹⁰⁴⁴ *Ibid*

¹⁰⁴⁵ *Ibid*

¹⁰⁴⁶ *Ibid*

¹⁰⁴⁷ *Ibid*

¹⁰⁴⁸ Banaji, J., "Islam, the Mediterranean and the rise of capitalism", *Historical Materialism*, 15, 1, (2007): 47–74.

¹⁰⁴⁹ *Ibid*

¹⁰⁵⁰ *Ibid*

¹⁰⁵¹ Kuran, T., "The Absence of the Corporation in Islamic Law: Origins and Persistence", *American Journal of Comparative Law*, 53, (2005): 785–834.

¹⁰⁵² Weebly, "Diminishing Musharakah", (2015), < <http://www.financialislam.com/diminishing-musharakah1.html>>

¹⁰⁵³ *Ibid*

¹⁰⁵⁴ *Ibid*

for the purchase of a certain predetermined percentage of SIB's contribution to the partnership.¹⁰⁵⁵ The respective contributions of the partners do not remain fixed at the end of every year.¹⁰⁵⁶

Whilst the idea of the Diminishing Musharaka is of recent origin, it has achieved substantial innovation.¹⁰⁵⁷ The Diminishing Musharaka (DM) being innovative and combining the major attributes of the Musharaka Mudaraba model and the sale principal of Islamic financing, substantial care should be taken against any violation of Sharia principal.¹⁰⁵⁸ The Sharia problem, in the case of the DM resolves around the fact that such a contract contains a sale provision.¹⁰⁵⁹ The financier agrees to sell a central part of its ownership share every year to the entrepreneur.¹⁰⁶⁰ Whilst some scholars feel that such a transaction is merely a promise, others feel it to be a sale transaction.¹⁰⁶¹ Several problems can arise from this interpretation.¹⁰⁶² Firstly if the sale transaction has occurred, how the financiers can put forward his claim on the profits of the enterprise.¹⁰⁶³ Secondly what is the exact amount of the price and what is the exact description of the object of sale.¹⁰⁶⁴ A sale provision of DM becomes null and void in the absence of the two.¹⁰⁶⁵ It is thirdly inequitable to make the entrepreneur binding to purchase something in the future.¹⁰⁶⁶ These issues arise from the legal status of a promise to sell or buy legally binding.¹⁰⁶⁷ Whilst Sharia experts have different opinions on this issue, it has been concluded for the sake of justice and efficiency in Islamic banking that a promise should be made binding.¹⁰⁶⁸ It must also further be investigated if the sale provision in the DM contract be made binding for both parties.¹⁰⁶⁹ The OIC Fiqh Academic Resolution No 2, states that sale provision of the contract can be made binding only on the financier and at the prices prevailing at the time of sale.¹⁰⁷⁰ The SIB thus put forward a variant of the DM wherein (a) the bank makes a binding promise to put a

¹⁰⁵⁵ *Ibid*

¹⁰⁵⁶ *Ibid*

¹⁰⁵⁷ Dabiri, M., "Diminishing Musharakah", (2012), < http://www.academia.edu/4246103/Diminishing_Musharakah>

¹⁰⁵⁸ *Ibid*

¹⁰⁵⁹ *Ibid*

¹⁰⁶⁰ *Ibid*

¹⁰⁶¹ *Ibid*

¹⁰⁶² *Ibid*

¹⁰⁶³ Weebly, "Diminishing Musharakah", (2015), < <http://www.financialislam.com/diminishing-musharakah1.html>>

¹⁰⁶⁴ *Ibid*

¹⁰⁶⁵ *Ibid*

¹⁰⁶⁶ Islamic Banker, "Diminishing Musharakah in Trade", (2016), < <https://www.islamicbanker.com/education/diminishing-musharakah-trade>>

¹⁰⁶⁷ *Ibid*

¹⁰⁶⁸ *Ibid*

¹⁰⁶⁹ *Ibid*

¹⁰⁷⁰ *Ibid*

specific part of the its ownership of the project on sale at a specific future date, (b) the purchase is not binding and (c) prices will be finalised only at the time of actual sale.¹⁰⁷¹ Quran stated that if the purchase of the financiers ownership is not made binding on the entrepreneur, one would be perfectly justified in questioning their rationale of the DM contract.¹⁰⁷² This is based upon the assumption that an entrepreneur has an inherent motivation for acquisition of ownership and would like to buy the ownership sold by a financier to his party when required.¹⁰⁷³ The financier is secondly bound by his promise to sell his ownership, whilst the entrepreneur will enjoy priority rights of purchasing assets.¹⁰⁷⁴

The salient features of a DM contract can be summarised as below.

- A client entrepreneur and a financier developed a joint project on the basis of a Musharaka.
- The profits are divided and shared according to an agreed ratio and losses in proportion to capital contribution.
- The financier makes a binding promise to sell its ownership shares of the enterprise on instalment.
- The client voluntarily buys the shares of the financier at the prices prevailing at the time of sale in order to ensure that the entrepreneur becomes sole owner at the maturity of the contract.
- Shares prices are determined in the stock market. With these markets not being efficient in the Muslim countries, the parties can agree to accept the share prices indicated by their auditors.
- The project may also be developed on orders of the client and thereafter hold to the client. The client will purchase the shares from the revenues generated by the project.
- The sale component of the DM contract is binding only on the financier.¹⁰⁷⁵

Dabiri examined the utility of DM in the purchase or construction of a house.¹⁰⁷⁶ If the motivation of construction of a house is for use by the self, residing in it or renting it rather than

¹⁰⁷¹ *Ibid*

¹⁰⁷² Kuran, T., "The Absence of the Corporation in Islamic Law: Origins and Persistence", *American Journal of Comparative Law*, 53, (2005): 785–834.

¹⁰⁷³ *Ibid*

¹⁰⁷⁴ *Ibid*

¹⁰⁷⁵ Iqbal, M., & Molyneux, P., *Thirty Year of Islamic Banking: History, Performance and Prospects*, (Palgrave Macmillan: NY, 2004).

for sale Mudaraba Musharaka becomes irrelevant.¹⁰⁷⁷ Whilst the UK government specified that the registration tax be paid twice over, the choice of DM as a suitable financing alternative has been discussed.¹⁰⁷⁸ A financial institution and a prospective owner-client may in such circumstances jointly construct or purchase the house.¹⁰⁷⁹ The client user may progressively buy the share of the financial institution regardless of market rent of the property.¹⁰⁸⁰ The two parties may alternatively opt for rent sharing as the client will buy the ownership of the financier, the financier's share in total rent will progressively reduce to zero with the decline in its ownership.¹⁰⁸¹

7.4.7 Islamic Finance in Saudi Arabia

The Kingdom of Saudi Arabia (KSA) is home to number of dedicated Islamic banks as well as Islamic window operations offered through conventional banks.¹⁰⁸² Islamic finance is a mature and developed industrial Saudi and represents about two thirds of total bank finances.¹⁰⁸³ Approximately 38% of such financing comes from Islamic banks and the balance 28% from the Islamic windows of conventional banks.¹⁰⁸⁴ The KSA has twelve licensed commercial banks, four of which are fully Sharia compliant and balance provide a mix of Sharia compliant and conventional banking services.¹⁰⁸⁵ Al Rajhi is the largest Islamic bank in the country as well as the largest international Islamic bank.¹⁰⁸⁶ The KSA is distinguished by the possession of large Islamic banks and mandates that both Islamic and commercial banks be supervised by a single authority and have similar requirements for disclosure.¹⁰⁸⁷

The Saudi Arabian Monetary Agency (SAMA) is responsible for such regulation.¹⁰⁸⁸ However the kingdom is predominantly Muslim in its demographics and is probably helping

¹⁰⁷⁶ Dabiri, M., “*Diminishing Musharakah*”, (2012), < http://www.academia.edu/4246103/Diminishing_Musharakah>

¹⁰⁷⁷ *Ibid*

¹⁰⁷⁸ *Ibid*

¹⁰⁷⁹ *Ibid*

¹⁰⁸⁰¹⁰⁸⁰ Iqbal, M., & Molyneux, P., *Thirty Year of Islamic Banking: History, Performance and Prospects*, (Palgrave Macmillan: NY, 2004).

¹⁰⁸¹ *Ibid*

¹⁰⁸² EIIB, “*Saudi Arabia: Gateway to Islamic Finance*”, (2015), < http://www.islamic-banking.com/resources/7/NewHorizon%20Previousue%20Issues/NewHorizon_JulySep08.pdf>

¹⁰⁸³ *Ibid*

¹⁰⁸⁴ *Ibid*

¹⁰⁸⁵ *Ibid*

¹⁰⁸⁶ Al Rajhi Capital, “*Saudi Mortgage law: Planning for the long-term*”, (2013), < http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

¹⁰⁸⁷ *Ibid*

¹⁰⁸⁸ Al-Shamrani, A.S., “*Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice*”, (2014), < <http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf>>

Islamic banks to grow swiftly.¹⁰⁸⁹ Saudi banks obtain benefits from local currency volumes and substantial liquid assets.¹⁰⁹⁰ The portfolios of Islamic and conventional banks however differ because the former has lesser investment options on account of Sharia tenets.¹⁰⁹¹ These essentially consist of deposits in cash and with the central bank, which are characterised by both low risks and low returns.¹⁰⁹²

Al Elsheikh and Tanega stated that the major driver of real estate expansion in the Middle East is being led by Saudi Arabia.¹⁰⁹³ Real estate companies are constantly working with Sharia compliant financing and this forms a key component of their requirements.¹⁰⁹⁴ A number of Sharia compliant real estate fund has been established in recent years.¹⁰⁹⁵ Sharia compliant real estate market requires financing for a property acquisition to be Islamic; the tenants of the property and the tenancy agreement also need to be Sharia compliant.¹⁰⁹⁶ A Sharia compliant property company cannot have any tenants that are involved in conventional financing activity.¹⁰⁹⁷ The tenancy agreement need them have the essential elements of Sharia complaints, such as the rent being fixed or subject to clearly defined formula for calculation to avoid uncertainty; the manner in which an Islamic real estate transactions will largely be determined by the nature of the real estate itself and the relevant ownership requirements.¹⁰⁹⁸

Sharia compliant real estate funding on a completed property is typically structured on the basis of a straightforward sale and lease back arrangements.¹⁰⁹⁹ The property will sell the property to the Islamic banks and which the property company then lease the property back from the Islamic bank by paying a rental, which replicates the economics of a conventional real estate functioning agreement.¹¹⁰⁰ The other Sharia issues in relation to the completed real estate are mainly associated with the use of the underlined property and its tenets.¹¹⁰¹ Where property is

¹⁰⁸⁹ *Ibid*

¹⁰⁹⁰ *Ibid*

¹⁰⁹¹ *Ibid*

¹⁰⁹² *Ibid*

¹⁰⁹³ Al Elsheikh, A., & Tanega, J., "Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia", *Law and Financial Markets Review*, 5, 3, (2011): 183, 200.

¹⁰⁹⁴ *Ibid*

¹⁰⁹⁵ *Ibid*

¹⁰⁹⁶ *Ibid*

¹⁰⁹⁷ Oxford Business Group, "Saudi Arabia's new mortgage law", (2016),

<<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁰⁹⁸ *Ibid*

¹⁰⁹⁹ Ali, J.I., "Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws", (2013), <

http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹¹⁰⁰ *Ibid*

¹¹⁰¹ *Ibid*

being acquired by either a Sharia compliant real estate funds or is to be purchased by an Islamic bank as part of a sale and lease back financing agreement.¹¹⁰²

The Sharia compliant financing structures required the property to invest.¹¹⁰³ It is important to appreciate that home owners in Saudi Arabia is just 30% compared to a global average of 70%; mortgage penetration is estimated at 2% of GDP.¹¹⁰⁴ Home financing options offered by Saudi banks have been extremely limited in the past.¹¹⁰⁵ The new package of mortgage laws is expected to stimulate home financing but commercial banks are still feeling their way towards using the laws in practice.¹¹⁰⁶

7.4.8 Progress of Standardisation in Islamic Finance in Saudi Arabia

Zulkhibri and Ghazal stated that Islamic finance across the world suffers from a lack of standardisation and standard setting of Sharia compliant.¹¹⁰⁷ The regulation for Islamic banking institution in most countries is formulated in the image of conventional banking practices.¹¹⁰⁸ Some countries do not have appropriate legal frameworks as well as inadequate laws for corporate governance.¹¹⁰⁹ Islamic banking theory in most countries agree that Islamic banking activities are essentially going to be based on the legal concepts of sharing of profit and loss and Sharia principle.¹¹¹⁰ It has been contended that Islamic banks provide their financial resources to their clients and borrowers, not for charging of interest but for sharing of profits and losses.¹¹¹¹ Whilst conventional interest based financing works on the assumption that all risks are assumed by the borrowers; Islamic banks share these risks through sharing of profits and losses.¹¹¹² Several laws and rules has been formulated, developed and modified by Islamic scholars in order to respond to the evolving economic environments; these are particularly relevant for Sharia

¹¹⁰² *Ibid*

¹¹⁰³ Deloitte, “Saudi mortgage laws A formula for a well-functioning market?”, (2013), <https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹¹⁰⁴ Deloitte, “Saudi mortgage laws A formula for a well-functioning market?”, (2013), <https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹¹⁰⁵ *Ibid*

¹¹⁰⁶ *Ibid*

¹¹⁰⁷ Zulkhibri, M., & Ghazal, R., “Standardisation of Islamic banking practices: a regulatory perspective”, *Afro-Asian Journal of Finance and Accounting*, 1, 1, (2014): 1-25.

¹¹⁰⁸ *Ibid*

¹¹⁰⁹ *Ibid*

¹¹¹⁰ *Ibid*

¹¹¹¹ *Ibid*

¹¹¹² Amin, A., “How industry standardisation in Islamic finance could help promote cross-border transactions”, (2012), <http://www.mohammedamin.com/Islamic_finance/Industry-standardisation-and-cross-border-Islamic-finance.html>

principles.¹¹¹³ Whilst sales based economic models differ from interest based financing and are allowed by the Sharia, theorists state that the diverse socioeconomic benefits of Islamic banking and the Islamic system of intermediation may not be accomplished in good measure until the proportion of profit and loss sharing models increases significantly in the total financing volumes.¹¹¹⁴ The practical difficulties associated with such financing have however resulted in its slow decline and correspondingly to a steady enhancement in the usage of what are referred to as financing mechanism with returns that are predetermined and thus somewhat similar to interest.¹¹¹⁵ It is important whilst discussing standardisation to note some pertinent characteristics of Islamic banks.¹¹¹⁶

- Islamic banks do not guarantee the capital value or the returns on investment deposits.
- Islamic banks appear to be better positioned to absorb sudden economic shocks than conventional banks on account of their use of profit and loss sharing and the structure of their balance sheets.
- Islamic banks should not be expected to lower credit risk by methodically calling for collateral or other guarantees before granting of PLS facilities.¹¹¹⁷

It is important to appreciate that the problems of international standardisation of Islamic banking can be attributed to the fact that Sharia principles vary amongst countries.¹¹¹⁸ the Sharia principle that are used by Islamic banks can essentially be segmented into four categories, i.e. sharing of profits and losses, basis for charging of fees, provisioning of free services and ancillary principles.¹¹¹⁹ Most of the Islamic banks use the principles of Musharaka, Mudaraba, Murabaha, Ijara and Qard Hasan. Islamic financial institutions furthermore need to demonstrate complete compliance with Sharia in both financial and non-financial activities, both to internal

¹¹¹³ *Ibid*

¹¹¹⁴ *Ibid*

¹¹¹⁵ *Ibid*

¹¹¹⁶ Dubai Media Incorporated, “*Islamic finance needs global standardisation of regulations*”, (2013), <<http://www.emirates247.com/business/economy-finance/islamic-finance-needs-global-standardisation-of-regulations-2013-07-31-1.516228>>

¹¹¹⁷ *Ibid*

¹¹¹⁸ Amin, A., “*How industry standardisation in Islamic finance could help promote cross-border transactions*”, (2012), <http://www.mohammedamin.com/islamic_finance/Industry-standardisation-and-cross-border-Islamic-finance.html>

¹¹¹⁹ *Ibid*

stakeholders, like members of the workforce and external stakeholders, like customers.¹¹²⁰ The achievement of Sharia compliance is critically important for achievement of credibility of Islamic banking and finance; it is important to appreciate that the Sharia board is an important element of the structure of Islamic bank in order to ensure compliance within Islamic financial institutions.¹¹²¹ The Sharia board is responsible for overseeing and reviewing all new products.¹¹²² It has to interpret different financial concepts in order to assess whether they include interest either directly or indirectly, it is also called upon to provide inputs for the creation of alternative banking services frameworks that conform to Islamic principles.¹¹²³

With regard to standardisation of Islamic finance practices, it is important to note that different countries are adopting different policies and methods to achieve standardisation.¹¹²⁴ The Accounting and Auditing Organisation for Islamic Institution (AAOIFI) has a key role in achievement of standardisation. Created through the alliance of various banks and the Islamic Development Bank, the AAOIFI's membership now includes governmental regulators and authorities.¹¹²⁵ The AAOIFI Sharia Standards 2010 consists of 41 standards and 11 stipulations that are concerned with Gharar, Zakat, and arbitration.¹¹²⁶ Its Accounting, Auditing and Governance Standards 2010 have 40 standards in areas of accounting, auditing, ethics and corporate governance.¹¹²⁷ The standards should be used by individual Islamic banks, as well as at the national level and are now being used in states like Bahrain, Dubai, Jordan, Sudan, Syria and Qatar.¹¹²⁸ It is pertinent to note that Saudi Arabia, along with Indonesia, Lebanon, Malaysia and the UAE have incorporated AAOIFI standards into national guidelines.¹¹²⁹ The absence or lack of standardisation of Islamic financial products is clearly preventing their cross border sale.¹¹³⁰ The AAOIFI has now announced a time table for adopting a more intrusive approach towards the

¹¹²⁰ *Ibid*

¹¹²¹ *Ibid*

¹¹²² *Ibid*

¹¹²³ *Ibid*

¹¹²⁴ *Ibid*

¹¹²⁵ Ahmed, A.M., & Ghuddah, A.S.A., "*Shariah Opinions (Fatwa) On Murabaha*", (2014), <<http://www.albaraka.com/media/pdf/Research-Studies/RSMR-200706201-EN.pdf>>

¹¹²⁶ *Ibid*

¹¹²⁷ *Ibid*

¹¹²⁸ *Ibid*

¹¹²⁹ *Ibid*

¹¹³⁰ *Ibid*

regulation of Islamic financial products.¹¹³¹ It however remains to be seen how its policy of greater intrusion will be accepted by Islamic financial institutions in different countries.¹¹³²

7.4.9 Role of Sharia Supervisory Boards in Saudi Arabia

The Sharia governance system as defined by the IFSB Guiding Principles on Sharia Governance System in institutions offering Islamic financial services is concerned with a set of institutional and organisational arrangements to supervise various aspects of Sharia compliance in Islamic financial institutions.¹¹³³ The majority of these institutions have set up their own Sharia board and some of them have even established dedicated internal Sharia review unit to support the board in its function.¹¹³⁴ There does appear to be a concerted effort by Islamic finance institutions to comply with Sharia principle in a methodical and systematic basis.¹¹³⁵ Such efforts to set up Sharia board notwithstanding the cause of standardisation are not really being achieved because of differences in various Sharia schools of thought.¹¹³⁶

The existing framework of Islamic finance in various jurisdictions thus demonstrates diverse prospects and models of the Sharia governance system.¹¹³⁷ Whilst some jurisdictions prefer greater involvement of regulatory authorities, others prefer greater autonomy.¹¹³⁸ Khan stated that Sharia governance model could be segmented into five types from perspectives of regulation.¹¹³⁹ These five governance models comprise (1) reactive approach, (2) proactive approach, (3) interventionist approach, (4) minimalist approach and (5) passive approach.¹¹⁴⁰

- **Reactive Approach:** The reactive approach is prevalent in non-Islamic legal environment countries, like the UK and Turkey. Whilst Islamic banking licenses have been issued to several institutions, the regulatory authority has until now been silent upon the Sharia governance framework. Islamic finance institutions are, like, other conventional banks, required to function within the

¹¹³¹ Zulkhibri, M., & Ghazal, R., "Standardisation of Islamic banking practices: a regulatory perspective", *Afro-Asian Journal of Finance and Accounting*, 1, 1, (2014): 1-25.

¹¹³² *Ibid*

¹¹³³ Mejia, A.L., Aljabrin, S., Awad, R., Norat, M., & Song, I., "Regulation and Supervision of Islamic Banks", *IMF*, IMF Working paper No. 14/219, (Washington: International Monetary Fund, 2014).

¹¹³⁴ *Ibid*

¹¹³⁵ *Ibid*

¹¹³⁶ *Ibid*

¹¹³⁷ Islamic Banker, "*Shariah Supervisory Board*", (2016), <<https://www.islamicbanker.com/education/shariah-supervisory-board>>

¹¹³⁸ *Ibid*

¹¹³⁹ Khan, F., "How "Islamic" is Islamic Banking," *Journal of Economic Behavior and Organization*, 76, (2010): 805–20.

¹¹⁴⁰ *Ibid*

ambit of existing laws and regulation. They are also obliged to ensure that their business operations and products are compliant with the Sharia. Specific legislation governing these institutions as well as directives that specify Sharia governance frameworks do not exist. Regulators will, at this point only react and intervene Sharia governance matters if any issue of significance that affects the industry arises. The UK FSA for example is only concerned with the fact that the Sharia on board the Islamic financial institution are only supervisory and advisory and not executive in nature.¹¹⁴¹

- Proactive Approach: The proactive approach is favoured by the Malaysian Regulatory Authority. Advocates of this body state that its regulatory based approach strengthened the Sharia governance framework. The Malaysian regulatory initiatives initiate comprehensive Sharia governance framework on both regulatory and non-regulatory aspects. Several laws have been passed in the last few decades that assess the role of Islamic financial institution and assist them in working within legal and regulatory guidelines.¹¹⁴²
- Interventionist Approach: The interventionist model is unique to Pakistan's Sharia governance model. This model allows third party institutions to make decisions on Sharia matters that pertain to Islamic finance. The Sharia Federal Court is the highest authority in matters involving Islamic finance. Despite the establishment of a Sharia board at the level of the State Bank of Pakistan.¹¹⁴³
- Minimalist Approach: The minimalist approach is practised by most GCC countries with the exception of Oman and Saudi Arabia. The minimalist model, unlike the reactive approach allows for slight intervention by regulatory authorities. The regulatory authorities in these countries expect Islamic financial institution to have suitable Sharia governance systems without specifying the requirements in detail. Restrictions have not been placed on multiple appointments on the Sharia board to seek in various institutions at a specific time. GCC nations like Bahrain, Qatar and Dubai have favoured the

¹¹⁴¹ El Tiby, A. M., & Wafik, G., *Islamic Finance and Economic Development*, (New Jersey: John Wiley & Sons, 2015).

¹¹⁴² Imam, P., & Kpodar, K., "Islamic Banking: How Has it Diffused?" IMF Working paper 10/195 (Washington: International Monetary Fund, 2010).

¹¹⁴³ Simon, A., & Karim, R. A.A., *Islamic Finance The New Regulatory Challenge*, (Singapore, Wiley, 2013).

adoption of AAOIFI governance standards. The minimalist approach prefers the market to build its Sharia governance system and decries greater involvement by regulators.

- **Passive Approach:** Saudi approach follows the passive approach model. The SAMA treats Islamic financial institution on par with their conventional counterparts and has not, until now initiated or issued any legislation that pertains to Islamic finance on the issue of Sharia governance. Sharia advisory board do not exist either at the national level or in institutions and as such do not play any role in Sharia compliance. The Sharia governance system in Saudi Arabia, with regard to Islamic financial institution, is thus a product of self-initiative rather than the regulatory requirement for the directors of the regulator. Saudi Arabia has adopted a flexible approach to Sharia compliance and Islamic financial institutions in the country function without Sharia oversight but adhere to the tenets of the Sharia in accordance with their own interpretation. The writer feels that such flexibility in Sharia interpretation can result in significant difficulties to being about standardisation amongst Islamic finance products in the country.¹¹⁴⁴

7.4.10 Regulatory Overview and Sharia Governance in Saudi Arabia

The banking and finance in Saudi Arabia, as explained earlier is controlled by the Saudi Arab Monetary Agency (SAMA), which was established by Royal Decree in December 1967.¹¹⁴⁵ Sharia is the main law of Saudi Arabia. Commercial matters are decided by commercial courts.¹¹⁴⁶ Islamic Financial Institutions emerged in the country in 1974.¹¹⁴⁷ It is important to keep in mind that all Saudi Islamic Financial institutions are not monitored by SAMA: they are monitored and organised as commercial companies by the Saudi Ministry of Commerce.¹¹⁴⁸

The growth of Islamic finance in the KSA has been unique.¹¹⁴⁹ The bank's control systems govern the legal framework, but has not provided any opinion on interest.¹¹⁵⁰ Most

¹¹⁴⁴ Song, I., & Oosthuizen, C., "Islamic Banking Regulation and Supervision: Survey Results and Challenges", *IMF*, (2014), <<https://www.imf.org/external/pubs/ft/wp/2014/wp14220.pdf>>

¹¹⁴⁵ Vissar, H., *Islamic Finance Principles and Practice*, (NY: Edward Elgar Publishing Limited, 2009).

¹¹⁴⁶ *Ibid*

¹¹⁴⁷ *Ibid*

¹¹⁴⁸ *Ibid*

¹¹⁴⁹ Edbiz Consulting, *Global Islamic Finance Report 2013*, (London: Edbiz Consulting, 2013).

business is conducted in the conventional manner.¹¹⁵¹ With the legal system being based on Islamic law, the legal framework is somewhat confusing and specific cases of malpractice, bribery and similar offences are reviews by specific institutions.¹¹⁵² The presence of lacunae in the Islamic finance framework has resulted in the development of unique Sharia governance systems. The practice of basic Sharia governance has occurred as a voluntary initiative and is characterised by self-regulation.¹¹⁵³

With there being a lacuna in the regulatory framework pertaining to Islamic finance in Saudi Arabia, the nature of its Sharia governance system differs from other jurisdictions.¹¹⁵⁴ The notion of basing the Sharia governance system within the financial institution has not occurred on account of any legal and supervisory requirements but more as a voluntary initiative and indirect market influence.¹¹⁵⁵ The Sharia governance model in Saudi Arabia is thus primarily based upon self-regulation. It is relevant at this point to refer to the Al Rajhi model.¹¹⁵⁶ The 11th general assembly of the Al Rajhi has established Sharia board and its charter.¹¹⁵⁷ The provision of the establishment of the Sharia board was clearly expressed in the articles of association as well as the internal rules and guidelines of the organisation.¹¹⁵⁸ The Sharia board of Al Rajhi is considered to independent of all organs of governance, like the management or board of directors as the appointment is made by shareholders at the annual general meeting.¹¹⁵⁹ The Sharia board at Al Rajhi plays four important roles in the furtherance and promotion of Sharia compliant.¹¹⁶⁰ The Sharia firstly monitors the activities and implementation of Sharia ruling with the help of the Sharia control department.¹¹⁶¹ The board secondly has to assist the bank in the development of products through the application of Sharia control instruments for local and international markets.¹¹⁶² The board also creates awareness about Islamic finance for external parties.¹¹⁶³

¹¹⁵⁰ *Ibid*

¹¹⁵¹ *Ibid*

¹¹⁵² *Ibid*

¹¹⁵³ *Ibid*

¹¹⁵⁴ Zulkifli, H., *Shariah Governance in Islamic Banks*, (Edinburgh: Edinburgh University Press, 2012).

¹¹⁵⁵ *Ibid*

¹¹⁵⁶ *Ibid*

¹¹⁵⁷ Al Rajhi Capital, “*Saudi Mortgage law: Planning for the long-term*”, (2013), < http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

¹¹⁵⁸ *Ibid*

¹¹⁵⁹ *Ibid*

¹¹⁶⁰ *Ibid*

¹¹⁶¹ EIIB, “*Saudi Arabia: Gateway to Islamic Finance*”, (2015), < http://www.islamic-banking.com/resources/7/NewHorizon%20Previous%20Issues/NewHorizon_JulySep08.pdf>

¹¹⁶² *Ibid*

¹¹⁶³ *Ibid*

7.4.11 Conclusions

Saudi Arabia occupies an extremely important place and plays a significant role in the contemporary Islamic finance environment.¹¹⁶⁴ The country is rigidly Islamic in its approach to governance and society and is governed by the Sharia or Islamic law.¹¹⁶⁵ The prevalence and dominance of Islamic law notwithstanding, it needs to be recognised that Saudi Arabia is also one of the leading global economies and a very busy commercial and global centre.¹¹⁶⁶ The Saudi government has in recent years also worked extensively on diversifying its economy away from its dependence on oil revenues and on building its industrial, trading and real estate sectors.¹¹⁶⁷ Such efforts notwithstanding, the real estate sector and especially residential mortgages in Saudi Arabia are far behind the western developed nation, both in terms of owned residential housing and penetration of mortgages.¹¹⁶⁸ Several conventional commercial banks from across the world operate in Saudi Arabia and play an important role in the functioning of the Saudi economy.¹¹⁶⁹ The country has also grown into a hub of Islamic finance in recent decade and a number of Islamic banks and financial institutions operate in the country.¹¹⁷⁰

Whilst the Islamic finance sector has grown steadily in Saudi Arabia, the country's governance has purely adopted a non-partisan approach towards Islamic financing activities.¹¹⁷¹ Both conventional and Islamic banks have to adhere to the same set of banking rules and regulations with regard to the provisioning of banking services.¹¹⁷² Regulation of Islamic and conventional banks in Saudi Arabia is carried out by SAMA and the organisation has been found to be quick and efficient in the detection of questionable activities.¹¹⁷³ With regard to the adherence of Saudi bank to the tenets of Sharia, research has revealed that real estate companies in Saudi Arabia are constantly working with Sharia compliant financing.¹¹⁷⁴ The government has

¹¹⁶⁴ Al-Shamrani, A.S., “*Islamic Financial Contracting Forms in Saudi Arabia: Law and Practice*”, (2014), <

<http://bura.brunel.ac.uk/bitstream/2438/9145/1/FulltextThesis.pdf>>

¹¹⁶⁵ *Ibid*

¹¹⁶⁶ *Ibid*

¹¹⁶⁷ Al Elsheikh, A., & Tanega, J., “Sukuk structure and its regulatory environment in the Kingdom of Saudi Arabia”, *Law and Financial Markets Review*, 5, 3, (2011): 183, 200.

¹¹⁶⁸ *Ibid*

¹¹⁶⁹ Oxford Business Group, “*Saudi Arabia's new mortgage law*”, (2016),

<<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹¹⁷⁰ *Ibid*

¹¹⁷¹ Deloitte, “*Saudi mortgage laws A formula for a well-functioning market?*”, (2013), <

https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹¹⁷² *Ibid*

¹¹⁷³ *Ibid*

¹¹⁷⁴ *Ibid*

adopted a reasonable passive approach towards the monitoring and supervision of Islamic banks.¹¹⁷⁵ Sharia governance framework in Saudi Arabia follows the passive approach to achieve parity with other Islamic banks.¹¹⁷⁶ It is however important to keep in mind that the government is yet to develop and create a national framework for all Saudi Arabian banks.¹¹⁷⁷ The aims of individual Saudi banks for enhancement of Sharia compliance and corporate governance are thus products of their self-initiative rather than regulatory requirements or the development of regulators.¹¹⁷⁸ It is felt that such a flexible system of oversight can result in negligence and poor results.¹¹⁷⁹ Such flexibility in Sharia compliance provides the managements of individual Islamic banks in Saudi Arabia with significant leeway to develop new financial products.¹¹⁸⁰ Such flexibility however goes against the tenets of standardisation of banking products and services. with individual banks in Saudi Arabia still to put in place Sharia authority, the chances for dissimilarities in the interpretation of Sharia tenets for the development of financial instruments is low.¹¹⁸¹ The process of standardisation in the Saudi Islamic sector is thus less aggressive than it is in the UAE, especially in Dubai.¹¹⁸²

The writer feels that the Islamic finance segment of the Saudi economy has enormous potential to grow but such growth is being obstructed by the lack of standardisation in Sharia rules and regulations, with specific regard to home mortgage transactions. The Saudi government has taken cognisance of the low growth of mortgage financing in Saudi Arabia and has introduced five new laws to encourage real estate activity.¹¹⁸³ These five laws are concerned with (1) real estate finance, (2) supervision of finance company's law, (3) finance lease law, (4) real estate mortgage law and (5) enforcement law.¹¹⁸⁴ These five laws aim to reduce lack of clarity amongst home builders and home buyers, enhanced transparency and result in expansion of both the real estate and the mortgage sector.¹¹⁸⁵

¹¹⁷⁵ Ali, J.I., "Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws", (2013), <http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹¹⁷⁶ *Ibid*

¹¹⁷⁷ *Ibid*

¹¹⁷⁸ Banaji, J., "Islam, the Mediterranean and the rise of capitalism", *Historical Materialism*, 15, 1, (2007): 47–74.

¹¹⁷⁹ *Ibid*

¹¹⁸⁰ *Ibid*

¹¹⁸¹ Ali, J.I., "Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws", (2013), <http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹¹⁸² *Ibid*

¹¹⁸³ Al Rajhi Capital, "Saudi Mortgage law: Planning for the long-term", (2013), <http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

¹¹⁸⁴ *Ibid*

¹¹⁸⁵ *Ibid*

7.5 Dubai Case Study

7.5.1 Laws Governing banks and Financial Institutions and their Operations in the UAE

The most relevant Laws, Decrees, Resolutions and Decisions in the field of Banking, Finance and related areas in the U.A.E. are elaborated below, as they appear in government documents, in the following table.¹¹⁸⁶

Table 13 Relevant Laws of UAE Banking and Finance

S. No	Legislation	Details
1.	Federal Law No. 10 of 1980	Concerning the Central Bank, The Monetary System and Organisation of Banking
2.	Federal Law No. 8 of 1984	Concerning Commercial Companies
3.	Federal Law No. 6 of 1985	Concerning Islamic Banks and Financial Institutions
4.	Federal Law No. 5 of the 1985	Concerning Civil Transactions
5.	Federal Law No. 18 of 1993	Concerning Commercial Transactions
6.	Central Bank Resolution No.123/7/92	Regarding Regulation of Money Changing Business in the U.A.E
7.	Central Bank Resolution No.164/8/94	Regarding Regulation of Financial Investment Companies and Banks, Financial and Investment Consultancy Institutions and Companies
8.	Central Bank Resolution No.126/5/95	Regarding Financial and Monetary Brokers
9.	Central Bank Resolution No.57/3/96	Regarding Representative Offices
10.	Central Bank Resolution No.58/3/96	Regarding Finance Companies
11.	Central Bank Regulation No. 24 for the Year 2000	Concerning Procedures for Anti-Money Laundering

¹¹⁸⁶ Al Tamimi & Company, “Islamic Finance A UAE Legal Perspective”, (2015), p 9, <
<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

7.5.2 **The Role of the Central Bank**

Article 5 of Law No. 10 of 1980 (“1980 Law”) provides that the Central Bank shall direct monetary, credit and banking policy and supervise its implementation in accordance with the State’s general policy and in such ways as to help support the national economy and the stability of the currency. The provisions of article are reproduced, as they appear, below:¹¹⁸⁷

1. Exercise the privilege of currency issue in accordance with the provisions of the 1980 Law.
2. Endeavour to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies.
3. Direct credit policy in such ways as to help achieve a steady growth of the national economy.
4. Organise and promote banking and supervise the effectiveness of the banking system according to the provisions of the 1980 Law.
5. Undertake the functions of the bank of the U.A.E Government within the limits prescribed by the 1980 Law.
6. Advise the U.A.E Government on financial and monetary issues.
7. Maintain the U.A.E. Government’s reserves of gold and foreign currencies.
8. Act as the bank for banks operating in the State.

The Central Bank has been granted substantial powers to enable it to carry out the above objectives particularly the organisation, promotion and supervision of the banking and financial system in the State.

7.5.3 **Islamic Banks, Financial Institutions and Investment Companies in U.A.E.**

Information about the legal provisions, governing the activities of Islamic banks, financial institutions and investment companies in the UAE are reproduced below as they appear in legal documents.

- Article 1 of Federal Law No. 6 of 1985 concerning Islamic Banks, Financial Institutions and Investment Companies defines Islamic banks, financial

¹¹⁸⁷*Ibid*, p 9

institutions and investment companies as “those companies whose Articles and Memorandum of Association include an obligation to apply the Islamic Sharia Law and that their operations would be conducted pursuant to Islamic Sharia Law”.

- Article 2 of the Law No. 6 of 1985 provides that such institutions are subject to the provisions of the 1980 Law in addition to Law No. 8 of 1984 relating to Commercial Companies. Such banks and institutions are required to adopt the form of a public joint-stock company and must, prior to commencing their operations, obtain a licence from the Central Bank.
- An Islamic Bank is entitled to commence all or any banking, commercial, financial or investment operations. In addition, it is also entitled to carry out any of the services and/or operations referred to in the 1980 Law. It may also establish companies or finance projects provided that such projects are undertaken pursuant to Sharia principles. An Islamic Financial or Investment Company is entitled to grant loans, provide credit facilities or finance projects. It may also invest in movable property in addition to its ability to accept deposits from the public to invest such monies in accordance with Islamic Sharia principles.
- Such Islamic Banks and financial institutions (including licensed branches and offices of foreign Islamic banks and financial institutions and investment companies) are exempt by virtue of Article 4 of Law No. 6 of 1985, from certain of the prohibitions imposed on commercial banks relating to: (i) carrying on for its own account commercial or industrial activities or acquire, own or trade in goods; (ii) acquire immovable property for its own account; and (iii) having interest rates to be paid by banks on deposits and the rate of interest and commission to be collected from customers. The Articles and Memorandum of Association of such companies must provide for the establishment of a Sharia committee of not less than 3 persons who will ensure the adherence by such companies to Sharia principles in their operations and contracts. The appointment of the relevant Sharia committee within each of these companies is subject to the approval of a Supervisory Sharia committee within the Ministry of Islamic Affairs.

- Since Islam is the religion of the United Arab Emirates as stated in the UAE Constitution, the UAE is ideally placed to play a leading role in Islamic finance. In addition, implementing Islamic financial mechanisms are well suited to the legal system as it is always better to be an owner rather than a security holder in any transaction. Further, the UAE Civil Code has a very strong Sharia foundation which supports the proper regulation of Islamic financial mechanisms. Finally, the judges in the UAE come from an Islamic background familiar with Islamic concepts and contracts. This fact will eventually lead to the speedy conclusion of matters as cases will not be required to be referred to experts as frequently as in the past. Accordingly, judgments will become more predictable leading to more certainty in Islamic banking transactions.¹¹⁸⁸

7.5.4 **Laws Regarding Specific Areas of Islamic Finance**

The contents of this section have been reproduced, as they appear in a publication on legal perspectives in the UAE on Islamic finance. This information has not been changed in anyway because it is specifically important for this dissertation on account of its clarification of the UAE perspective on Islamic finance.

7.5.4.1 The Prohibition of Interest

Riba represents, in the Islamic economic system, a prominent source of unjustified advantage. All Muslim scholars are adamant that this prohibition extends to any and all forms of interest and that there is no difference between interest-bearing funds for the purposes of consumption or investment, since Sharia does not consider money as a commodity for exchange. Instead, money is a medium of exchange and a store of value. The UAE Federal Law No. 5 of 1985 Concerning Civil Transactions (the ‘Civil Code’), which was issued with the aim of achieving maximum compliance with the Sharia, recognizes this principle, and states in Article 714: “If the contract of loan provides for a benefit in excess of the essence of the contract otherwise than a guarantee of the rights of the lender, such provision shall be void but the contract shall be valid.”¹¹⁸⁹

¹¹⁸⁸*Ibid*, p 9-10

¹¹⁸⁹*Ibid*, p 2

7.5.4.2 Profit and Loss Sharing

Profit and Loss Sharing is a form of partnership, where partners share profits and losses on the basis of their capital share and effort. Unlike interest-based financing, there is no guaranteed rate of return. Islam supports the view that Muslims do not act as nominal creditors in any investment, but are actual partners in the business. It is comprised of equity-based financing. The justification for the PLS-financier's share in profit is his effort and the risk he carries, since his profit would have been impossible without the investment. Similarly, if the investment has made a loss, his money would be lost.¹¹⁹⁰

7.5.4.3 Gharar

Any transaction that involves Gharar (i.e. uncertainty and speculation) is prohibited. Parties to a contract must have actual knowledge of the “subject matter” of the contract and its implications. An example of an agreement tainted with Gharar is an agreement to sell goods which have been already lost. Thus far, Islamic scholars have approved certain basic types of contracts as being compliant with the principles of Islamic finance, and which may be used by Islamic banks to attract funds and to provide financing in a truly Islamic way. Before going into the peculiarity of each and every type of contract, there are, in general, four conditions required to affect a valid contract, namely

1. A price that is agreed mutually and not under duress.
2. Between parties that are sane and have the legal capacity to understand the implications of their actions.
3. At the time of contracting, the subject matter of the contract should be in existence and able to be delivered without uncertainty or deception.
4. The contract should not be based upon a consideration (for the purposes of this brochure, this is translated as counter-value) that is itself prohibited under the Sharia (e.g. alcohol, pork products, etc.)

In accordance with these conditions, the UAE Civil Code in Article 129 states: “The necessary elements for the making of a contract are:

- That the two parties to the contract should agree upon the essential elements

¹¹⁹⁰*Ibid*, p 2

- The subject matter of the contract must be something which is possible and defined or capable of being defined and permissible to be dealt in
- There must be a lawful purpose for the obligation arising out of the contract.¹¹⁹¹

7.5.4.4 Mudaraba (Trust Financing)

Mudaraba is a form of partnership in which one partner provides the capital required for funding a project (Rabul-amal), while the other party (known as a Mudarib), and manages the investment using his expertise.¹¹⁹² Although similar to a partnership, it does not require a company to be created, so long as the profits can be determined separately. Profits arising from the investment are distributed according to a fixed, pre-determined ratio.¹¹⁹³ The loss in a Mudaraba contract is carried by the capital-provider unless it was due to the negligence, misconduct or violation of the conditions pre-agreed upon by the Mudarib.¹¹⁹⁴ In a Mudaraba, the management of the investment is the sole responsibility of the Mudarib, and all assets acquired by him are the sole possession of Rab-ul-amal.¹¹⁹⁵ However, the Mudaraba contract eventually permits the Mudarib to buy out the Rab-ul-amal's investment and become the sole owner of the investment.¹¹⁹⁶

Mudaraba may be concluded between the Islamic bank, as provider of funds, on behalf of itself or on behalf of its depositors as a trustee (please note this has a different meaning to the English law concept of trustee) of their funds, and its business-owner clients. In the latter case, the bank pays its depositors all profits received out of the investment, after deducting its intermediary fees. It may also be conducted between the bank's depositors as providers of funds and the Islamic Bank as a Mudarib.

Mudaraba can either be restricted or unrestricted. Where unrestricted, depositors authorize the bank to invest their funds at its discretion. In the restricted Mudaraba, the depositors specify to the bank the type of investment in which their funds should be invested. The UAE Civil Code includes a chapter under the title of "Mudaraba", Article (693) thereof

¹¹⁹¹ *Ibid*, p 2-3

¹¹⁹² Sohbetna.com, "Federal Law No. 6 "On Islamic Banks, Financial Establishments and Investment Companies", (2009), <<http://www.sohbetna.com/business/uaelaw/federallawno6onislamicbanksfinancialestablishments/>>

¹¹⁹³ *Ibid*

¹¹⁹⁴ Mousavian, S.A., Vosough, B., & Arani, F.A., "Murabaha Mortgage Backed Securities - A New Financial Instrument for Islamic Banking", (2008), <<http://conference.qfis.edu.qa/app/media/274>>

¹¹⁹⁵ *Ibid*

¹¹⁹⁶ *Ibid*

states: “A Mudaraba is a contract whereby the person owning property puts in the capital, and the Mudarib puts in effort or work, with a view to making a profit.”¹¹⁹⁷

7.5.4.5 Musharaka (Partnership Financing)

Musharaka is often perceived as an old-fashioned financing technique confined in its application to small-scale investments. Although it is substantially similar to the Mudaraba contract (see above), it is different in that all parties involved in a certain partnership provide capital towards the financing of the investment. Profits are shared between partners on a pre-agreed ratio, but losses will be shared in the exact proportion to the capital invested by each party. This gives an incentive to invest wisely and take an active interest in the investment.

Moreover, in Musharaka, all partners are entitled to participate in the management of the investment, but are not necessarily required to do so. This explains why the profit-sharing ratio is left to be mutually agreed upon and may be different from the actual investment in the total capital. In a typical Musharaka between a bank and a customer (i.e., partner), at the time of distribution of profits, the customer pays the bank its share in the profits and also a pre-determined portion of his own profits, which then reduces the bank’s shareholding in the investment.

Eventually, the customer becomes the complete and sole owner of the investment. The UAE Civil Code recognises Musharaka in a general way and states in Article 654 thereof: “A company is a contract whereby two or more persons are bound each to participate in a financial project by providing a share of property or work for the exploitation of that project and the division of any profit or loss which may arise there out.”¹¹⁹⁸

7.5.4.6 Murabaha (Cost plus Financing)

Murabaha is the most popular form of Islamic financing techniques. Within a Murabaha contract, the bank agrees to fund the purchase of a given asset or a good from a third party at the request of its client, and then resells the assets or goods to its client with a mark-up profit. The client purchases the goods either against immediate payment or for a deferred payment. This

¹¹⁹⁷*Ibid*, p 3

¹¹⁹⁸*Ibid*, p 3-4

financing technique is sometimes considered to be akin to conventional, interest-based finance. However, in theory, the mark-up profit is quite different in many respects.

The mark-up is for the services the bank provides, namely, seeking out, locating and purchasing the required goods at the best price. Furthermore, the mark-up is not related to time since, if the client fails to pay a deferred payment on time, the mark-up does not increase due to delay and remains as pre-agreed. Most importantly, the Bank owns the goods between the two sales and hence assumes both the title and the risk of the purchased goods, pending their resale to the client. This risk involves all risks normally contained in trading activities, in addition to the risk of not necessarily making the mark-up profit, or if the client does not purchase the goods from the bank and whether he has a justifiable excuse for refusing to do so.

However, the Organisation of the Islamic Conference (“OIC”) has declared that a customer’s promise to purchase the goods in a Murabaha is an ethically binding promise. Accordingly, the OIC Academy has held that the customer is bound to compensate the bank for any out of pocket expenses the latter incurs as a result of the refusal of the customer to purchase the goods. The purchase of goods under the Murabaha contract may be funded by the Islamic Bank either from its own funds, or from the funds of its depositors. In the latter case, the bank acts as its depositors’ agent, retaining its fees from the mark-up profits. In such circumstances, the depositors will own the purchased goods during the period pending its resale, and therefore assume its risk.

Article 506 of the UAE Civil Code covers Murabaha Sales as

1. A sale may be by way of resale with a profit, a loss, or at cost price if the capital value of the thing sold is known at the time of the contract, and the amount of the profit or loss is specified.
2. If it appears that the seller has exaggerated in declaring the amount of the capital value, the purchaser may reduce (the amount) by the amount of the excess.
3. If the capital value of the thing sold is not known when the contract is made, the purchaser may rescind the contract when he learns of it, and the same shall apply if the seller conceals a matter affecting the thing sold or the capital value, and he shall lose his right to elect if the goods are sold or consumed or pass out of his ownership after delivery.¹¹⁹⁹

¹¹⁹⁹ *Ibid*, p 4

7.5.4.7 Ijara (Leasing)

Ijara is defined as sale of Manfa'a (i.e., sale of right to utilise the goods for a specific period). The Ijara contract is very similar to the conventional lease. Under Islam leasing began as a trading activity and then much later became a mode of finance. Ijara is a contract under which a bank buys and leases out an asset or equipment required by its client for a rental fee. The jargon accorded to the financier, that is the bank, is "lessor", and to the client, "lessee. During a pre-determined period, the ownership of the asset remains in the hands of the lessor who is responsible for its maintenance so that it continues to give the service for which it was rented.

Likewise, the lessor assumes the risk of ownership and in practice seeks to mitigate such risk by insuring the asset in its own name. Under an Ijara contract, the lessor has the right to re-negotiate the quantum of the lease payment at every agreed quarterly interval. This is to ensure that the rental remains in line with prevailing market leasing rates and the residual value of the leased asset. Article 742 of the UAE Civil Code defines the Ijara as; "A hire shall be the conferring by the lessor on the lessee of the right of use intended for the thing hired for a specified period in consideration of an ascertained rent.

Under this contract, the client does not have the option to purchase the asset during or at the end of the lease term since this is considered under the Sharia to be tainted with uncertainty. Yet, this may be reached under another contract, very similar to Ijara (known as an Ijara wa Iktina (Hire-purchase)) except that there is, at the outset, a commitment from the client to buy the asset at the end of the rental period at an agreed price with the rental fees previously paid constituting part of the price.

7.5.4.8 Salam (Advance Purchase)

Salam is defined as forward purchase of specified goods for full forward payment. This contract is regularly used for financing agricultural production. Article 568 of the UAE Civil Code defining Salam states: "A forward sale is for property, the delivery of which is deferred, against a price payable immediately.

Article 569 of the UAE Civil Code states its requirements:

The following conditions must be satisfied for a forward sale to be valid:

1. The property must be such as can be specified by description and quantity, and it must normally be available at the time of delivery.
2. The contract must contain particulars of the nature, type, description and amount of the goods, and the time at which they are to be delivered.¹²⁰⁰

7.5.4.9 Istisna'a (Commissioned Manufacture)

Istisna'a is a new concept in modern Islamic finance that offers a number of future structuring possibilities for trading and financing. In this contract, one party buys the goods and the other party undertakes to manufacture the goods, according to agreed specifications. Islamic financial practice holds that the contract is binding on both parties at the outset. Islamic banks frequently use Istisna'a to finance construction and manufacturing projects. There is no specific article in UAE law that expressly refers to and deals with Istisna'a, however, the official commentary to the UAE Civil Code stipulates that the Sharia principles of Istisna'a are to apply in the case of construction contracts (Muqawala) as defined in Article (872) thereof, that states: "A muqawala is a contract whereby one of the parties thereto undertakes to make a thing or to perform work in consideration which the other undertakes to provide".¹²⁰¹

7.5.5 Standardisation Issues in Islamic Financing / Musharaka Contracts in Dubai

The reading of available literature reveals that lack of standardisation constitutes one of the most important areas of concern within this sector. Hussain Alqemzi GCEO of Noor investment Group and CEO of Noor Islamic Bank stated that standardisation of the regulations governing Islamic finance was essential for ensuring the globalisation of Islamic finance.¹²⁰² He stated that the absence of standardisation was retarding the expansion of Islamic finance.¹²⁰³ The standards followed by Islamic banks differed from nation to nation and it was an issue of concern that an authoritative global body did not exist for the regulation and promotion of Islamic finance.¹²⁰⁴ It

¹²⁰⁰ *Ibid*, p 4-5

¹²⁰¹ *Ibid*, p 5

¹²⁰² Zawya, "Noor Islamic Bank's CEO Calls For Global Body to Regulate Islamic Finance Industry", (2013), <<http://www.zawya.com/mena/en/story/ZAWYA20130731090151/>>

¹²⁰³ *Ibid*

¹²⁰⁴ *Ibid*

Sohail Jaffer, Deputy CEO of FWEU stated that whilst the first modern bank adhering to Islamic finance principles, i.e. Dubai Islamic Bank was established in 1975.¹²⁰⁵ The concept of Islamic finance has experienced organic and sporadic growth with the establishment of Takaful providers, Sharia compliant asset managers and Sharia advisors.¹²⁰⁶

Sharia compliant mortgages had the proviso that the monies collected from the safe execution of outstanding revenues would help in reducing the level of conflict.¹²⁰⁷ The Muskun Home Financing section of Bank Islami provides home financing facilities based on the principles of diminishing Musharaka and Ijara.¹²⁰⁸ The bank states that the diminishing Musharaka is based on the Shirkat ul-Milk; the bank and the borrower jointly own the specific asset.¹²⁰⁹ This is followed by the leasing of the bank's share with the help of Ijara, which is divided into several units.¹²¹⁰ An agreement is finally arrived, with the client being authorised to periodically purchase bank owned units and increase his share until he obtains ownership of all units.¹²¹¹

The role of standardisation in enhancing the growth of Musharaka usage amongst population is more than evident.¹²¹² It is for example agreed that there is a difference of opinion amongst different schools of thought in Islam whether the capital invested in the operation of Musharaka has to be in liquid form.¹²¹³ Different schools of thought have different approaches to the issue with regard to Musharaka being based on money or commodities.¹²¹⁴ Imam Malik felt that liquidity was certainly not a relevant condition for the validity of Musharaka; even if a partner contributes in kind to the partnership, his share can be determined on the basis of the evaluation in terms of the prevalent market price at the date of the contract.¹²¹⁵

Some schools of thought state that the burden of loss will have to be borne by all.¹²¹⁶ This line of thinking has two positive attributes, namely (1) the burden of loss, in case of its

¹²⁰⁵ **The European, “Islamic Finance: An expert analysis”, (2014), <<http://www.the-european.eu/story-8395/islamic-finance-expert-analysis.html>>**

¹²⁰⁶ *Ibid*

¹²⁰⁷ *Ibid*

¹²⁰⁸ BankIslami, “MUSKUN Home Financing, (2016), <http://bankislami.com.pk/product_services/muskun/>

¹²⁰⁹ *Ibid*

¹²¹⁰ *Ibid*

¹²¹¹ *Ibid*

¹²¹² Ghoul, A.W., “The Standardization Debate in Islamic Finance: A Case Study”, (2013), <<http://conference.qfis.edu.qa/app/media/277>>

¹²¹³ *Ibid*

¹²¹⁴ *Ibid*

¹²¹⁵ Islamic Banker, “Issues Relating to Musharakah”, (2015), <<https://www.islamicbanker.com/education/issues-relating-to-musharakah>>

¹²¹⁶ *Ibid*

occurrence will be shared by all firms and not fall upon one and (2) capital, if it provided at the time of the agreement will stay blocked for the period during which the machinery will be imported.¹²¹⁷

Disagreements have also been voiced over fixing the period of a Musharaka agreement.¹²¹⁸ It should be kept in mind that the following conditions are important for fixing the tenure of the Musharaka.

- The partnership is fixed for such a long time that no other business can be conducted at the completion of the period.
- The partnership can be short and n either of the partners is allowed to dissolve it.

¹²¹⁹

The Hanafi School of Thought asserts that the tenure of partnership should be fixed as it is an agency agreement.¹²²⁰ The Hanbul School of Thought feels that the tenure for the partnership can be fixed as it is an agency agreement, which can be fixed as per the tenets of the school.¹²²¹ The Maliki School however states that a partnership cannot be subjected to fix tenure.¹²²² The Shafi School, like the Maliki feels that fixing the tenure is not permissible as it will prohibit conduct of business at the end of that period.¹²²³

The case of standardisation has been discussed in detail by Ghoul, who stated that the growth of the Islamic finance industry has been hampered to a great extent by the absence of consensus amongst Sharia scholars from diverse schools of thought.¹²²⁴ Such diversity has led to continuous disagreements about the acceptability of particular features of Islamic financial products.¹²²⁵ Standardisation entails the establishment of universal Sharia standards, which in turn would eliminate existing difficulties and divergences on Sharia interpretation.¹²²⁶ The call for establishing Sharia standards has however not found universal acceptance.¹²²⁷ Advocates of standardisation state that standardisation should make the process of product development more

¹²¹⁷ *Ibid*

¹²¹⁸ *Ibid*

¹²¹⁹ *Ibid*

¹²²⁰ *Ibid*

¹²²¹ *Ibid*

¹²²² *Ibid*

¹²²³ *Ibid*

¹²²⁴ Ghoul, A.W., “*The Standardization Debate in Islamic Finance: A Case Study*”, (2013), <<http://conference.qfis.edu.qa/app/media/277>>

¹²²⁵ *Ibid*

¹²²⁶ *Ibid*

¹²²⁷ *Ibid*

efficient and remove the vulnerability caused by Sharia arbitrage; such standardisation would also prevent institutions as well as consumers from shopping around for Sharia products that suited their objectives.¹²²⁸ Standardisation would also help in the integration of Islamic financial markets into those which are international.¹²²⁹ Critics and opponents of standardisation however feel that it would inhibit innovation and would never be achieved in the absolute sense.¹²³⁰

Hamad Bu Amin, president and Chief Executive of the Dubai Chambers of Commerce and Industry (DCCI) stated that the UAE needs a Sharia board to standardise products in Islamic finance.¹²³¹ He added that the asset growth of Islamic banks in the GCC is outstripping their conventional peers and that standardisation could enhance asset growth and product innovation in the area.¹²³²

The study of case studies on Musharaka Financing in Dubai revealed that Musharaka was a type of partnership developed by two or more entities, who combined either their capital or their labour together and shared the profits or loss of the partnership.¹²³³ It was seen that Musharaka's should have valid contracts and that the profit shared proportion must be clearly determined and agreed by all partners at the time of the contract.¹²³⁴ The majority of Muslims jurists appeared to agree that the capital investment in a Musharaka should be in the form of money rather than in the shape of goods. Jurists also state that all partners have the right to participate in Musharaka management and that in case of loss each partner should suffer the loss to the ratio of its investment.¹²³⁵

It was seen that Islamic banks in the Middle East and the GCC region engaged in two types of Musharaka, i.e. the Consecutive Musharaka and the diminishing Musharaka.¹²³⁶ IFN News stated that the Musharaka financing arrangement has come to be widely regarded as the purest form of Islamic financing.¹²³⁷ In permanent Musharaka, an Islamic bank participates in the equity of a project and is entitled to a share of the profit on a pro rata basis. The length of the

¹²²⁸ *Ibid*

¹²²⁹ *Ibid*

¹²³⁰ *Ibid*

¹²³¹ Mayankar, S.S., “*Standardisation required to promote Islamic finance in UAE*”. (2014), <<http://gulfnews.com/business/sectors/banking/standardisation-required-to-promote-islamic-finance-in-uae-1.1405665>>

¹²³² *Ibid*

¹²³³ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <

<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

¹²³⁴ *Ibid*

¹²³⁵ *Ibid*

¹²³⁶ *Ibid*

¹²³⁷ *Ibid*

contract is not specified, which makes it suitable for the financing of projects that require fund commitment over a long period.¹²³⁸ Diminishing Musharaka on the other hand allows for equity participation and profit sharing on a pro rata basis and provides a system for ensuring that the bank progressively reduces its equity in the project and ultimately transfers ownership of the assets to the partners.¹²³⁹

7.5.6 **Standardisation and Sharia Compliance in Dubai**

The UAE is making numerous efforts to promote the practice of Islamic finance, despite the presence and operations of several conventional banks.¹²⁴⁰ The UAE government has passed specific legislation, with regard to Islamic banks and Islamic financial institutions, article 1 of Federal Law No 6 of 1995, required them to conduct business in accordance with the Sharia; this furthermore needs to be elaborated in the memorandum and articles of association of these institutions.¹²⁴¹ Dubai presents a unique position in this regard because the UAE authority had passed a specific law known as the Dubai International Financial Centre Law No 13 of 2004, which provides the legal framework for law regulating Islamic finance business and the Sharia board.¹²⁴² The Sharia governance system in the UAE, except for Dubai is governed by Federal Law no 6 of 1985.¹²⁴³ The law calls for the establishment of a higher Sharia authority for the monitoring and supervision of Islamic banks and for the delivering of opinions on issues that are concerned with.¹²⁴⁴ Apart from a Higher Sharia Authority, which is established by the government, Sharia scholars in the UAE have voluntarily initiated the establishment of a central committee of the Sharia supervisory board for harmonisation and modernisation of the Sharia supervisory board.¹²⁴⁵ With regard to conflict of interest, the law states that financial institution in the UAE must have mechanisms in the form of policies and procedures for the management of potential conflict of interest of the Sharia board of directors.¹²⁴⁶ The Islamic financial institution

¹²³⁸ *Ibid*

¹²³⁹ *Ibid*

¹²⁴⁰ Oxford Business Group, “*Islamic finance holds promise for Dubai*”, (2015), <<http://www.oxfordbusinessgroup.com/news/islamic-finance-holds-promise-dubai>>

¹²⁴¹ *Ibid*

¹²⁴² *Ibid*

¹²⁴³ Basit, A., “*Call for Shariah-compliant products' standardisation*”, (2015), <<http://www.khaleejtimes.com/business/banking-finance/call-for-shariah-compliant-products-standardisation>>

¹²⁴⁴ *Ibid*

¹²⁴⁵ *Ibid*

¹²⁴⁶ Siddiqui, R., “*Standardisation of practices critical to growth of Islamic Finance*”, (2010), <<http://gulfnews.com/business/sectors/banking/standardisation-of-practices-critical-to-growth-of-islamic-finance-1.655985>>

should also provide reasonable assistance to the Sharia board, with specific regard to right of access to relevant records and information.¹²⁴⁷ Islamic financial institutions in Saudi Arabia required adopting the AAOIFI governance standards wherever they are obliged to produce the Sharia annual report.¹²⁴⁸ The Islamic financial institution must assure that the internal Sharia review is performed by the internal audit function or the compliance function, either at part of the existing internal audit or compliance department or independent external Sharia audit department of the financial institution.¹²⁴⁹

7.6 Discussion

This chapter of the research project has engaged in a comprehensive discussion of the practice of Islamic finance with specific reference to the practice of Islamic finance, mortgage laws and regulation, the home loans environment and the financial crisis in the United Arab Emirates. These issues were studied in great detail for the UK, Sharjah, Saudi Arabia and Dubai. The review revealed that the UAE, bolstered by its substantial oil revenues has been able to achieve a per capita income that is by and large comparable to those of the advanced West European nations.¹²⁵⁰ Whilst Sharjah and Dubai have been adversely affected on account of the financial crisis of 2008-2009, reduction in oil prices and a significant slump in real estate activity, they have been able to avoid the political turmoil associated with the Arab Spring that has affected Egypt and other countries in the Middle East.¹²⁵¹ Whilst the financial crisis originated in the USA and spread across the interconnected financial and banking systems of North and West Europe, its impact was transmitted to the UAE through contraction in global economic activity, crashing real estate prices and excessive leveraging of financial debt.¹²⁵²

Real estate developers and financial institutions were especially affected, which in turn led to sharp escalation in mortgage default and financial distress for several listed commercial banks.¹²⁵³ The working of all the stock exchanges in the GCC was affected adversely and the

¹²⁴⁷ *Ibid*

¹²⁴⁸ *Ibid*

¹²⁴⁹ *Ibid*

¹²⁵⁰ Mayankar, S.S., “Standardisation required to promote Islamic finance in UAE”. (2014), <<http://gulfnews.com/business/sectors/banking/standardisation-required-to-promote-islamic-finance-in-uae-1.1405665>>

¹²⁵¹ *Ibid*

¹²⁵² *Ibid*

¹²⁵³ Jaber, H., “Impact of the Global Financial Crisis on GCCUAE's Banking Sector”, (2012), <<http://bspace.buid.ac.ae/bitstream/1234/109/1/80108.pdf>>

stock indices declined by as much as 40 to 60% in 2009.¹²⁵⁴ To the surprise of many experts, Islamic banks were able to withstand the impact of the crisis in 2008 much better than conventional banks but were badly affected in 2009 in what is considered to be the second round impact of the crisis on the real estate market and the GCC economies.¹²⁵⁵ Islamic banks, it is felt were able to withstand the crisis better because of their higher capital and liquidity buffers, which protected them in times of losses and their Sharia compliant financing agreement.¹²⁵⁶

It is important to appreciate that the banking sector of the UAE has been subjected to a new set of mortgage lending regulations; the new set of regulation aims to ensure that mortgage lending in the UAE is carried out in accordance with best practice and appropriate framework.¹²⁵⁷ These regulations are also applicable to conventional bank and Islamic financing institution engaged in the provisioning of Sharia compliant loans for property purchase.¹²⁵⁸ This is an extremely important development because it brings conventional and Islamic banks under the same regulatory framework with regard to mortgage lending.¹²⁵⁹ The regulations are very clear and provide details for mortgage eligibilities for UAE national and expatriates.¹²⁶⁰ Specific detailing has been provided for finance availability with specific regard to loan to value, both for first and second loan.¹²⁶¹ Rules have also been put in place to ensure that valuation is carried out in a methodical and transparent manner by expert valuers.¹²⁶² The UAE has also carried out specific legislation for Islamic banks, stating that they are obliged to enforce the provisions of the Islamic Sharia and shall be subject to Federal Law no 10 of 1980 and Federal Law no 8 of 1984.¹²⁶³ These establishments shall be formed as general joint stock companies and entitled to carry out various kinds of activities and services in compliance with the provisions of the Islamic Sharia.¹²⁶⁴

The UAE has also decided to establish a higher Sharia organisation, which shall be entrusted with the responsibility of ensuring that Islamic banks and financial institutions engage

¹²⁵⁴ *Ibid*

¹²⁵⁵ *Ibid*

¹²⁵⁶ *Ibid*

¹²⁵⁷ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <

<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

¹²⁵⁸ *Ibid*

¹²⁵⁹ *Ibid*

¹²⁶⁰ *Ibid*

¹²⁶¹ Augustine, D.B., “*New UAE mortgage regulations target property speculation*”. (2016), <

<http://gulfnews.com/business/sectors/banking/new-uae-mortgage-regulations-target-property-speculation-1.1248713> >

¹²⁶² *Ibid*

¹²⁶³ *Ibid*

¹²⁶⁴ *Ibid*

in transactions that are Sharia compliant.¹²⁶⁵ The decision of the higher Sharia organisation shall be binding on all Islamic banks and financial institutions in the UAE.¹²⁶⁶ This is an extremely important and interesting development because it constitutes an important initial step towards standardisation.¹²⁶⁷ It can be assumed that the higher Sharia authority shall be consistent in its approach towards the interpretation of the Sharia and provide guidelines that can be followed by all Islamic banks in the UAE when developing mortgages and other financial instruments.¹²⁶⁸

All Islamic banks and financial institutions shall furthermore be required to establish an internal Sharia control organisation, which shall be responsible for providing Sharia related guidance, advice and instruction to their bank.¹²⁶⁹ The names of the members of the Sharia control organisation shall furthermore be submitted to the higher organisation.¹²⁷⁰ The researcher feels that the UAE has acted with great foresight, first to ensure Sharia compliance in the operations and actions of Islamic banks and second to achieve a significant degree of standardisation in the process.¹²⁷¹

Careful Sharia compliant will help in attracting customers who are eager to achieve Sharia compliance in their financial and business activity.¹²⁷² Standardisation shall furthermore help in achieving a high degree of uniformity in the actions of the various Islamic banks operating in the region.¹²⁷³ It is also important to keep in mind that the UAE is governed by a civil law system and separate legislation for the codification of Sharia law for commercial transactions does not exist at present.¹²⁷⁴ Whilst the UAE does not have Sharia courts to attend to disputes that are concerned with Sharia financing transactions, several features of Sharia ruling have been incorporated into civil law.¹²⁷⁵ Whilst the higher Sharia authority and the Sharia organisation within individual Islamic banks will certainly be expected to achieve success in the development of Sharia compliant financial instruments, these instruments should also be in

¹²⁶⁵ *Ibid*

¹²⁶⁶ John, I., "UAE Central Bank issues new mortgage rules", (2013), <<http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

¹²⁶⁷ *Ibid*

¹²⁶⁸ *Ibid*

¹²⁶⁹ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), <<http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

¹²⁷⁰ *Ibid*

¹²⁷¹ *Ibid*

¹²⁷² *Ibid*

¹²⁷³ Ghoul, A.W., "The Standardization Debate in Islamic Finance: A Case Study", (2013), <<http://conference.qfis.edu.qa/app/media/277>>

¹²⁷⁴ *Ibid*

¹²⁷⁵ *Ibid*

conformity with the civil law of the UAE.¹²⁷⁶ Banking experts have expressed some misgivings about transactions that fall into grey areas, like for example derivatives transactions.¹²⁷⁷ The UAE laws are silent on the issue of derivatives transactions, even though such transactions should be outside the ambit of Islamic law because of their uncertain and speculative attributes.¹²⁷⁸

The study revealed that the main barrier in the structuring and offering of Sharia compliant products involved the overcoming of occasional gaps between Sharia principles and UAE laws.¹²⁷⁹ Whilst many principles of Sharia law have been embedded in the UAE civil code, provisions of UAE laws have been found to be inconsistent with the Sharia in some aspects.¹²⁸⁰ It is also relevant to note that commercial law have been shaped by several influences but some differences continue to exist. Entertainment and pork is for example not illegal in the UAE but prohibited by Sharia.¹²⁸¹ Various experts have stated that such discrepancies between civil code of the country and the Sharia should be eliminated in order to save bankers and their clients from unnecessary inconveniences.¹²⁸² Disputes, when they arise are likely to be settled in accordance with the civil code rather than the Sharia.¹²⁸³ The investigation found that several Islamic finance investments are available in the UAE.¹²⁸⁴ The Murabaha has some characteristics that make it specifically suitable for securitisation, both in the primary and in the secondary markets.¹²⁸⁵

The study of Islamic finance and its practice in Dubai revealed that the central bank, like in Sharjah had the powers to promote, monitor and supervise the working of Islamic banks and financial institutions in the country.¹²⁸⁶ All organisations obliged to apply the Islamic Sharia law were expected to be public joint stock companies and licensed by the central bank.¹²⁸⁷ Islamic financial companies were entitled to grant loans, provide credit facilities, finance projects except deposits, invest in moveable property and otherwise in accordance with Islamic Sharia

¹²⁷⁶ *Ibid*

¹²⁷⁷ *Ibid*

¹²⁷⁸ *Ibid*

¹²⁷⁹ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <

<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

¹²⁸⁰ *Ibid*

¹²⁸¹ *Ibid*

¹²⁸² *Ibid*

¹²⁸³ *Ibid*

¹²⁸⁴ *Ibid*

¹²⁸⁵ *Ibid*

¹²⁸⁶ John, I., “*UAE Central Bank issues new mortgage rules*”, (2013), < <http://www.khaleejtimes.com/business/local/uae-central-bank-issues-new-mortgage-rules>>

¹²⁸⁷ *Ibid*

principles.¹²⁸⁸ Each of these organisations was, like in Sharjah expected to appoint an appropriate internal Sharia committee and provide information about its members to a supervisory Sharia committee within the ministry of Islamic affairs.¹²⁸⁹ The study of Islamic finance in Dubai furthermore clarified that the UAE was ideally placed to play a leading role in Islamic finance.¹²⁹⁰ The region had a clearly elucidated uniform civil code with a very strong Sharia foundation.¹²⁹¹

Whilst Sharia courts had not been established in Dubai and Sharjah, it was well recognised that Sharia principles were embedded in the uniform civil code.¹²⁹² The study furthermore revealed that accepted Islamic finance activities like (1) the prohibition of interest, (2) profit and loss sharing, (3) Gharar, (4) Mudaraba, (5) Musharaka, (6) Murabaha and (7) Ijara were commonly used.¹²⁹³ The Diminishing Murabaha is commonly used for the purchase and sale of residential or commercial property.¹²⁹⁴ This financial instrument was found to be very suitable for contracting outside but it was necessary to find an appropriate outsourcing supplier.¹²⁹⁵ The study of standardisation in Dubai revealed that its absence had become a matter of significant concern and worry for the local Islamic finance community.¹²⁹⁶ Several senior Islamic finance officials have commented that the absence of such standardisation was retarding the expansion and spread of Islamic finance, both within the UAE and in other parts of the world.¹²⁹⁷ It was revealed that Islamic finance had experienced growth that was sporadic and organic with the establishment of Takaful providers, Sharia compliant asset managers and Sharia advisors.¹²⁹⁸ The progressive acceptance of Islamic banking by Muslim communities across the world had resulted in its growth and in the establishment of regional standard bodies.¹²⁹⁹

Sharia standards however deferred from country to country and region to region despite the existence of such bodies.¹³⁰⁰ It was thus a matter of some concern that an authoritative global

¹²⁸⁸ *Ibid*

¹²⁸⁹ *Ibid*

¹²⁹⁰ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), <<http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

¹²⁹¹ *Ibid*

¹²⁹² *Ibid*

¹²⁹³ *Ibid*

¹²⁹⁴ Weebly, "Diminishing Musharakah", (2015), <<http://www.financialislam.com/diminishing-musharakah1.html>>

¹²⁹⁵ *Ibid*

¹²⁹⁶ *Ibid*

¹²⁹⁷ Dabiri, M., "Diminishing Musharakah", (2012), <http://www.academia.edu/4246103/Diminishing_Musharakah>

¹²⁹⁸ *Ibid*

¹²⁹⁹ *Ibid*

¹³⁰⁰ Islamic Banker, "Diminishing Musharakah in Trade", (2016), <<https://www.islamicbanker.com/education/diminishing-musharakah-trade>>

body had not developed for the regulation and promotion of Islamic finance.¹³⁰¹ The examination revealed that several Islamic finance investments like the Diminishing Murabaha and the Diminishing Musharaka could be taken up for securitisation.¹³⁰² The role of standardisation in enhancing the growth of Musharaka usage in Islamic banking is also clearly evident.¹³⁰³ It is thus a matter of significant concern that different schools of thought have different approaches to Musharaka, with particular regard to it being based on money or on commodities.¹³⁰⁴ Several disagreements have also come to the fore over the fixing of the period for a Musharaka agreement between different schools of thought, especially the Hanafi, the Hanbul and the Maliki schools.¹³⁰⁵ The researcher has come to the conclusion from his study of the practice of Islamic finance and banking in the UAE, with particular regard to Sharjah and Dubai that the government is making specific efforts to enhance the growth and spread of Islamic banking through appropriate legislation that equates it with conventional banking.

There is however little doubt that conventional banking, driven by profit seeking approaches and managed by ambitious managers provide a much wider variety of choices to investors, borrowers and home seekers.¹³⁰⁶ Islamic banking is possibly managed in a more conservative manner with particular regard to liquidity and capital buffers, which enables it to withstand bad market condition and credit shocks with greater effectiveness.¹³⁰⁷ The Sharia compliant approaches of Islamic banks, which prohibit speculation of any type also increase risk resilience.¹³⁰⁸ Such positive attributes in areas of risk management and risk resilience notwithstanding, it is more than evident that the conventional banking sector is far more streamlined and standardised than Islamic banking.¹³⁰⁹ There appears to be a significant absence of standardisation, both in Sharjah and in Dubai.¹³¹⁰ The UAE central bank, which controls and monitors banking activity amongst the member states of the UAE has specifically called for the establishment of Sharia organisations within each Islamic bank and an overarching Sharia

¹³⁰¹ *Ibid*

¹³⁰² *Ibid*

¹³⁰³ *Ibid*

¹³⁰⁴ *Ibid*

¹³⁰⁵ *Ibid*

¹³⁰⁶ Bewley, A.A., Malik ibn Anas, I., *The First Formulation of Islamic Law*, (Madinah Press Inervess: Scotland, 2001).

¹³⁰⁷ *Ibid*

¹³⁰⁸ *Ibid*

¹³⁰⁹ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <

<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

¹³¹⁰ *Ibid*

committee for the state as the case may be.¹³¹¹ These Sharia committees are expected to advise their banks on various Islamic financial investments, including Musharaka and Mudaraba and ensure their Sharia complaints.¹³¹²

The establishment of an overarching Sharia committee for the state and its cooperative functioning with the Sharia committees of individual banks as well as other countries could certainly result in the progressive standardisation of all Islamic banking activities across the UAE.¹³¹³ This in turn could result in substantial expansion in the issuance of mortgages with consequently lower mortgage cost and to robust growth in the housing sector.¹³¹⁴ The researcher feels that the board of directors of the company should indeed show greater initiative in supporting and kick starting the business. True standardisation in the area of mortgaging, leasing, Musharaka, Mudaraba and others could result in a sharp spike in banking activity and result in significant benefits for Islamic banks and their clients.¹³¹⁵ The housing sectors of both these countries could also be reinvigorated by such developments and reverse the current slump in real estate activity.¹³¹⁶ [You should introduce the next section with a transition sentence.]

Information on Islamic finance in the UK revealed that the process of Islamic finance is facing specific challenges on account of existing regulatory processes. With Islamic products being based upon religious principles and tenets, their underlying structure can diverge substantially from their secular counterparts despite their similarity in economic consequences. The Murabaha, the Islamic mortgage instrument, which is used for purchase of property by individuals, is substantially different from the structure of secular mortgages. This may result in differences in definition and adverse consequences for their adoption by various banks. The launching of a savings account by the Islamic Bank of Britain, for example suffered on account of differences with the ways in which a deposit was defined by the FSA. Difficulties have also arisen in the regulation of the Sharia supervisory boards within UK law. With the FSA fulfilling a secular, rather than a religious role, it is bound to have difficulties in distinguishing between different interpretations of Islamic law and providing customers with assurances about whether specific products are Sharia compliant. The study also revealed that a substantially major

¹³¹¹ *Ibid*

¹³¹² *Ibid*

¹³¹³ *Ibid*

¹³¹⁴ *Ibid*

¹³¹⁵ *Ibid*

¹³¹⁶ *Ibid*

proportion of the Islamic financial products that are being offered in the UK by banks are unlikely to be Sharia compliant.

Apart from these difficulties, the Islamic financial sector is considered to be innovative and fast growing. The UK government aims to make the country a global hub for Islamic finance, an objective that is bound to find favour with the country's substantial Muslim population. Whilst some legal glitches and inadequacies in Sharia compliance can retard this process, experts feel that these issues shall be ironed out in some time.

The investigation of the progress of Islamic banking in Saudi Arabia revealed that the country has made significant progress in the development of a mortgage sector by introducing new laws with regard to real estate financing. Supervision of finance companies, finance leases, real estate mortgages and enforcement. The real estate mortgage law calls for the registration of mortgages and allows second ranking and successive mortgages to be made. The enactment of the new laws should help banks, financial institutions and consumers through development of higher liquidity, enhancement in number of participants, providing legal recourse to members, improving transparency and documentation and securing lending by property, rather than salary.

The examination revealed that Saudi Arabia has several dedicated Islamic banks and that several conventional banks operate Islamic windows. Islamic finance in the country accounts for approximately 67% of total banking finance. The country has several banks that provide fully Sharia compliant products and other that provide a mix of both Sharia compliant and conventional banking services.

Real estate expansion in the Middle East is being led by Saudi Arabia and several Sharia compliant real estate funds have been established in the country in recent years. With regard to standardisation, the examination of Islamic financing in Saudi Arabia continued to suffer from some lack of standardisation. Most banks made use of the principles of Musharaka, Mudaraba, Ijara and Murabaha, but were yet to demonstrate substantial compliance with the Sharia. The majority of finance institutions have established their own Sharia boards; these boards however conform to different school of Sharia thought, which makes standardisation difficult. The Saudi banking infrastructure is also characterised by some distinctive features, namely silence on the issue of interest, even though the country's legal system is based on and calls for stringent adherence to the tenets of the Sharia by all banks.

7.7 Conclusions

This chapter contains the findings of research carried out on Islamic banking and the provisioning of mortgage services in four different jurisdictions, namely the UK, Sharjah, Saudi Arabia and Dubai. The examination of Islamic finance in the UK revealed that the activity commenced in the country in the 1980s and has since then been growing at a steady pace. Islamic banking has an attractive market in the UK on account of the substantial Muslim population in the country.

The UK government has been making considerable efforts to ensure that Islamic banks grow in the country and that the UK becomes a global Islamic finance hub. These efforts, which have involved some legal relaxations by way of elimination of double stamp duty for housing mortgages, have certainly helped the cause and Islamic banking in the UK is now substantially stronger than in other European countries. It however needs to be kept in mind that the UK is a common law country and conventional banking activities are regulated by the Bank of England, the country's government and the Basel Accords. Islamic banking on the other hand is governed by Islamic religious doctrines, which contains stipulations about the nature of the relationship with banker and client, the prohibition of interest and the banning of speculative activity amongst other things. These circumstances are bound to result in dichotomies and discrimination between conventional and Islamic bank practices as well as substantial confusion amongst regulators. The examination of the UK Islamic banking sector also revealed that the majority of banking products on offer were unlikely to be Sharia compliant in the strict sense and were furthermore characterised by lack of standardisation. These issues were likely to result in different types of challenges, with particular regard to enforcement of contract and customer satisfaction with regard to adherence to religious edicts.

The examination of Islamic financing in Saudi Arabia revealed that the activity has grown substantially and now contributes more than two thirds of Saudi business activity. Saudi Arabia is an extremely important state in the realm of Islamic financing. Its substantial oil based wealth is now being productively used to generate business activity in different sectors and reduce national economic dependence on all through suitable diversification.

The Saudi Arabian government plans to make mortgage financing into a booming activity and has, for this reason introduced several new laws in areas of mortgaging, enforcement and finance. These laws are also aimed at easing the problems being faced by customers and banks

and in expanding mortgaging and financing activity. The government has in fact changed the concept of provisioning of security and has facilitated the offering of the house property, rather than salary in order to safeguard the interests of the lender. The case study however revealed that standardisation of Islamic products was still considerably inadequate; such inadequacies in standardisation essentially stemmed from differences in the opinions of different Sharia boards. The inability of these Sharia board to develop common ground and arrive at a common understanding of Islamic law on various aspects of Islamic finance made it extremely difficult to develop and implement standardised products, services and policies across banks.

The study of Islamic financing and mortgaging in Sharjah and Dubai revealed that the country has become an important regional player on account of its oil wealth and its moderate foreign policy. Islamic banks and conventional banks in the UAE face risks that are comparable because the chief risk for both types of banks relates to credit and the risk profile of conventional and Sharia compliant banking organisations are similar. Islamic banks cannot however obtain any sort of direct exposure to the securities of conventional financial institutions with particular regard to financial derivatives. The Central Bank of the UAE has recently issued regulations on mortgage lending, which is based on loan to property value ratios. The Central Bank aims to ensure that banking and financial organisations engaged in mortgage lending adhere strictly to control frameworks, regardless of their operating under the conventional banking system or in accordance with the tenets of the Sharia.

The regulation provides for mortgage funding that is limited to a specific percentage of the value of the property; such percentage depends upon the value of the property and the nationality of the borrower. Islamic banks are required to comply with the provisions of the Sharia as also to specific federal laws. They are to be set up in the form of joint stock companies and have the authority to carry out banking, commercial, financial and investment services. The higher control of Islamic bank is in the hands of a superior Sharia organisation.

Islamic financing in the UAE has grown over the years and has become an important alternative to the established conventional banking system. Diverse barriers and obstacles on the structuring of Islamic financial products are being addressed and removed in order to make them competitive with conventional banks. It needs to be kept in mind that the Sharia does not constitute a codified law in the UAE. Whilst it does not prescribe general legal principles, it aims to deal with specific transactions in order to ensure justice and eliminate exploitation. The UAE

is governed by a civil law system and does not have Sharia courts; it should however be kept in mind that several elements of the Sharia have been incorporated into civil law. The main challenge in the development of Islamic compliant products in the UAE thus relate to the bridging of differences and gaps between Sharia principles and the country's laws. Interest, for example is allowed but is prohibited from being excessive. Even dealing with pork and the entertainment industry is not illegal in the UAE. UAE laws are also silent on the use of derivatives transactions. The case study also revealed that most of the financial services of Islamic bank in the UAE can be taken up for securitisation. Murabaha in fact has specific features, namely a specific income, low risk or default and specific timing of maturity. These features make it ideal for purposes of securitisation.

Chapter 6: Discussion of Results

8.1 Introduction

This research project aimed to examine the practice of Islamic finance in the contemporary environment, with particular regard to the legal system and financial processes of mortgages in the Royal Kingdom of Saudi Arabia. The dissertation aims to reveal the ways in which Islamic mortgages can be conceived and implemented in a Sharia compliant manner under a general theory of securitisation in order to enhance the real estate and housing market in Saudi. The research project thus aims to determine how securitisation as a law and finance set of techniques could be used to theorise on the minimum legal condition for general market acceptability of Islamic mortgages. It furthermore aims to set practical guidelines for expanding the market base in jurisdictions where house ownership was considered an important factor for economic and social developments. The dissertation has made use of a carefully conceived theoretical framework and extensive study and investigation to arrive at results and findings.

Care has been taken to select and study an extensive range of information sources in the form of journal articles, books, research articles and other media publications on the subject. The complete dissertation has been carried out under the broad observation of the primary tenets of Islamic law, i.e. the prohibition of Riba for interest and the ban on Gharar, i.e. speculative activity. Another constant underlined field of the study has been the intention of Islamic finance to provide concrete and real socioeconomic benefits to the people.

The Islamic finance sector has attempted to develop a working philosophy and a range of mechanism for profitable and successful work and expansion, keeping these three actors, i.e. prohibition of interest, ban on speculative activity and generation of socioeconomic benefits and have developed a model for sharing of profit and loss (PLS), which achieves all three objectives and yet satisfies the fund requirements of borrowers and the business and social objectives of banks. The examination of Islamic banking was restricted to four specific geographies, namely the UK, Sharjah and Dubai (2 states within the UAE), Saudi Arabia, the oil rich economic powerhouse of the Middle East. The intense research carried out in the course of this project resulted in the elaboration of some specific features of Islamic finance, namely the (1) the role and impact of Sharia on Islamic banking, lending and mortgaging activity, (2) the impact of differences amongst different schools of Sharia on Islamic banking and financing activities, (3)

the absence of standardisation amongst Islamic banking across the world, with especial regard to Sharia and (4) the ways and means being adopted by different geographies to enhance the growth of Islamic banking.

It is important to keep in mind that the UK and the European Union have in recent times sought to enhance Islamic financing activity in their jurisdiction through suitable legislative and other measures.¹³¹⁷ Islamic banking in the UK must comply with common civil law in the country but the law makers have shown the foresight to remove double taxation from Islamic mortgaging contracts and thereby provided some reliefs to mortgage buyers.¹³¹⁸ The European Union has in a recent directive asked for greater information disclosure for Islamic mortgages assuming that greater transparency of information will result in more credibility for Islamic finance and its greater acceptance amongst mortgage buyers.¹³¹⁹

8.2 **Discussion and Analysis**

This section contains an extensive discussion and analysis of the information obtained in the course of this research project. The research has covered the wide area of the theoretical and practical aspects of Islamic banking and financing, with particular regard to its role and impact in four specific geographies, the UK, Sharjah, Dubai and Saudi Arabia. The UK has been chosen for study as it is the strongest centre of Islamic finance in the non-Islamic group of nations. Saudi Arabia, Dubai and Sharjah have been chosen because of their importance in global trade and economic activity as also their geographical importance in the east west routes of trade. The researcher has chosen to focus on these four geographies in order to be able to engage in in-depth analysis; this approach has resulted in the exclusion of the study of Islamic finance in countries like Egypt, Malaysia and Pakistan. This can be seen as a limitation of the study because Islamic finance has developed in different ways in different locations and by different schools of Sharia thought. The researcher has focused on five specific themes for discussion because of their role and relevance in the examination of Islamic finance, mortgaging and securitisation, which are the essential topics of research for the study.

¹³¹⁷ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

¹³¹⁸ *Ibid*

¹³¹⁹ Samra, S., “*HSBC scraps Sharia compliant mortgages*”, (2012),

<<http://www.mortgagesolutions.co.uk/news/2012/10/05/hsbc-scraps-sharia-compliant-mortgages/>>

8.2.1 Impact of Prohibition of Riba and Gharar on Islamic Financing

The prohibition of giving or taking of Riba or interest is one of the basic tenets of the Islamic religion and forms the foundation of Islamic finance.¹³²⁰ Its prohibition has been taken up in several places in the Quran as also in the sayings of the Prophet Mohammed.¹³²¹ These two religious sources on Riba have been subjected to close investigation by Islamic scholars in order to determine what can be considered to be Riba and what is outside its realm.¹³²² The prophet associated the taking of Riba with unequal economic status between two parties and the exploitation of the weaker party, i.e. the user of fund by the stronger party, namely the provider of funds.¹³²³ The Sharia stipulates that charging a weaker party for the use of money is exploitative and must be prohibited in order to ensure the socioeconomic benefits of business.¹³²⁴

The prohibition of Riba in Islamic banking, financing and trading activities has at one stroke differentiated Islamic banking from conventional commercial banking and ensured that they follow separate trajectories for growth and expansion.¹³²⁵ Conventional banking activity is based upon financial intermediation that occurs on account of interest.¹³²⁶ Individuals place interest carrying deposits with banks, which are thereafter pooled together and disbursed to banking customers in the form of loans.¹³²⁷ Banks charge interest for loan and pay interest on deposit; the difference between interest received and interest paid forms a critical element of their growth income, which is used to meet operational and administrative expenses and provides residual profits.¹³²⁸ With Islam not allowing the giving or taking of interest in any form whatsoever, Islamic finance and banking has had to develop business model, banking products and financial instruments that provide borrowers with funds, banks with deposits from the public and specific methods of financial intermediation.¹³²⁹ Islamic banks have attempted to solve this

¹³²⁰ Hamoudi, A.H., "Present at the resurrection: Islamic finance and Islamic law", *American University International Law Review*, 26, 4, (2011): 1107-1123.

¹³²¹ Gavin, J., Gibson, N., McCrum, P., & Summers, M., "Annual Review of Islamic Banking and Finance", *Hilal Publications*, (2010), <<http://thegulfonline.com/source/IslamicBankingReview.pdf>>

¹³²² *Ibid*

¹³²³ *Ibid*

¹³²⁴ Gait, A.H., & Wrthington, A.C., "A Primer on Islamic Finance: Definitions, Sources, Principles and Methods", University of Wollongong, School of Accounting and Finance Working Paper Series No. 07/05, 2007, <<http://ro.uow.edu.au/cgi/viewcontent.cgi?article=1359&context=commpapers>>

¹³²⁵ Freshfields Bruckhaus Deringer, F.B., "Islamic Finance: Basic principles and Structures. A focus on Project Finance", (2006), <<http://www.nzibo.com/IB2/basicPS.pdf>>

¹³²⁶ *Ibid*

¹³²⁷ Ercanbrack, J., "The regulation of Islamic finance in the United Kingdom", *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

¹³²⁸ *Ibid*

¹³²⁹ *Ibid*

issue by devising a method of financial intermediation that is essentially based upon the sharing of profits and losses.¹³³⁰ The adoption of this method of financial intermediation has allowed Islamic banks to satisfy both the personal and business needs of their clients. It forms the basis for acceptance of deposits from the clients as well as providing of funds for homes, personal needs for businesses through Murabaha, Musharaka, Ijara or other contracts as the case may be.¹³³¹ It has furthermore resulted in the development of a risk management system that is very different from that of conventional commercial banking and has its own set of benefits and limitations.¹³³²

It is important to appreciate that Islamic financial institution have had to face different types of technical problems in their quest for development of business models that are based upon profits sharing and not on interest.¹³³³ Such challenges have from time to time also influenced some of these institutions to develop business model that aim to provide returns by way of specific and predetermined mark-ups rather than a fair share of profits.¹³³⁴ Such business models have again been criticised for their similarity to the charging of interest.¹³³⁵ Many Islamic banks now have Sharia experts in place who determine whether specific financial products that are offered to the public are essentially Sharia compliant, with specific regard to Riba, Gharar and the sharing of profits and losses.¹³³⁶

The various forms of financing and leasing products developed by Islamic banks and financial institutions must also confirm to the tenets of Sharia.¹³³⁷ Gharar on the other hand is concerned with transactions that can be speculated in nature.¹³³⁸ The Islamic religion is very clear that all business and financial transactions must fundamentally be based upon the tenets of transparency, accuracy and disclosure of complete information.¹³³⁹ Whilst the prohibition of speculative activity is clearly one element of Gharar, it can also be associated with the need to ensure that the use of asymmetric information does not provide unfair advantages to one of the

¹³³⁰ El-Gamal, M., *A Basic Guide to Contemporary Islamic Banking and Finance*, (Rice University, Houston: USA, 2000).

¹³³¹ *Ibid*

¹³³² *Ibid*

¹³³³ Eisenberg, D., & Nethercott, C., *Islamic finance: law and practice*, (London: Routledge Publishers, 2012).

¹³³⁴ *Ibid*

¹³³⁵ *Ibid*

¹³³⁶ Balala, M.H., *Islamic finance and law: theory and practice in a globalised world*, (NY: I B Tauris Co Ltd, 2011).

¹³³⁷ *Ibid*

¹³³⁸ Alwosabi, M., “*The prohibition of Gharar*”, (2010), < http://staff.uob.edu.bh/files/620922311_files/Prohibition-of-Gharar.pdf>

¹³³⁹ *Ibid*

parties involved in a business deal compared to the other.¹³⁴⁰ The prohibition of Gharar is meant to ensure the satisfaction of all parties in the contract.¹³⁴¹ The prohibition of Gharar thus extends to any transactions that contain wilful misrepresentation of contractual term, gambling, fraud and cheating.¹³⁴² Several Sharia scholars have also stated that speculative or forward contracts should be examined from the perspectives of Gharar before they can be considered to be Sharia compliant.¹³⁴³

The prohibition of Gharar can thus specifically affect Murabaha contract that do not have material terms in place.¹³⁴⁴ It is thus evident that the prohibition of Riba and Gharar certainly constraints the options and flexibility available to Islamic financial institutions in their efforts to provide diverse types of financial products to their clients.¹³⁴⁵ Each and every financial product must as such be examined from the perspectives of prohibition of Riba and possibility of speculative activity before being offered to clients.¹³⁴⁶ Whilst it is not difficult to decide upon contracts from the perspectives of Riba, the detection of Gharar is a more complex and challenging task and has resulted in several types of interpretations by Sharia scholars and to disagreements between them on the Sharia compliance of specific financial products.¹³⁴⁷

8.2.2 Implications of Profit and Loss Sharing on Banking Activity

Islamic banks and other financial institutions have had to find out ways and means to develop viable business models to circumvent the prohibition of Riba, accept deposits from clients and provide funds to retail and business clients.¹³⁴⁸ Conventional banks base their complete business upon the acceptance and disbursement of money against interest.¹³⁴⁹ Their complete business model is based upon achievement of organisational earnings through the

¹³⁴⁰ *Ibid*

¹³⁴¹ Al-Omar, F., & Abdel-Haq, M., *Islamic Banking: Theory, Practice & Challenges*, (Oxford University Press: London & New Jersey, 1996).

¹³⁴² Alexakis, C., & Tsikouras, A., "Islamic finance: regulatory framework – challenges lying ahead", *International Journal of Islamic and Middle Eastern Finance and Management*, 2, 2, (2009): 90-104.

¹³⁴³ *Ibid*

¹³⁴⁴ Al Bashir, M., *Risk management in Islamic finance*, (London: Routledge Publishers, 2008).

¹³⁴⁵ *Ibid*

¹³⁴⁶ *Ibid*

¹³⁴⁷ Ahmad, Y.A-R., "Riba, Its Economic Rationale and Implications", *IIBI*, (1990), <http://www.islamic-banking.com/iarticles_8.aspx>

¹³⁴⁸ Ariss, R., "Competitive Conditions in Islamic and Conventional Banking: A Global Perspective", *Review of Financial Economics*, (2010): 101-108.

¹³⁴⁹ *Ibid*

charging and paying of interest.¹³⁵⁰ These banks furthermore aim to secure the safety of their funds through the obtaining of collateral security from their clients.¹³⁵¹ Such collateral provides them with the option to sell the collateral security in cases of default and make up their losses.¹³⁵² Islamic banks very clearly do not have this facility and have attempted to circumvent this problem by developing financial products that involve the sharing of profits, losses and risk between the provider and user of funds.¹³⁵³ A simple lending and borrowing agreement in conventional banking is thereafter replaced by a complex model that involves the sharing of profits, losses and risks.¹³⁵⁴

Islamic banks have thus developed a several financial products where profits, losses and risk are shared between the bank and the user of funds.¹³⁵⁵ This is clearly evident in classical Murabaha transaction, where assets are purchased by the financial institution on behalf of the client and thereafter sold by the bank to the client for a profit, which covers the costs of the efforts of the bank and the risk taken by the bank in financing the transaction for the client for a specific period.¹³⁵⁶ With the bank owning the asset though not possessing it for the period of a lease transaction, the profit covers the risk undertaken by the bank and enables it to earn a surplus at the end of the transaction.¹³⁵⁷

It is important to keep in mind that the developments of business models involving the sharing of profits, losses and risk have become the corner stone of Islamic financing.¹³⁵⁸ The prohibition of interest has resulted in the development of a totally different business model that involves far greater communication and coordination between financial institutions and clients and adds a totally different dimension to risk management and the sharing of risk.¹³⁵⁹ Islamic banks thus enter into contract with their clients that are not based upon the earning of predetermined interest on the monies borrowed but on the sharing of profits, losses and risks.¹³⁶⁰

¹³⁵⁰ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., "Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA", *Islamic Economic Studies*, 15, 2, (2008): 23-76.

¹³⁵¹ Hasan, M., & Dridi, J., "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study", *International Monetary Fund*, IMF Working Paper, (2010), <www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf>

¹³⁵² *Ibid*

¹³⁵³ *Ibid*

¹³⁵⁴ *Ibid*

¹³⁵⁵ Haassan, K., & Mahlkecht, M., *Islamic capital markets: products and strategies*, (NY: John Wiley & Sons, 2011).

¹³⁵⁶ *Ibid*

¹³⁵⁷ *Ibid*

¹³⁵⁸ Hoq, M. Z., Sultana, N., & Amin, M., "The Effect of Trust, Customer Satisfaction and Image on Customers' Loyalty in Islamic Banking Sector", *South Asian Journal of Management*, 17, 1, (2010): 70.

¹³⁵⁹ ISRA Bulletin, "Time to Move to the Next Phase of Islamic Finance: Risk Sharing and its Significance in Islamic Finance", (2012), <<http://ifkr.isra.my/documents/10180/16168/bulletin13.pdf>>

¹³⁶⁰ *Ibid*

The incurrence of losses by borrowers can thus jeopardise the money provided by financial institutions and force them to share in the losses of their clients.¹³⁶¹ With business activity being subject to a multitude of production, marketing, financial and reputational risk, the risk exposure of Islamic financial institution is far more than in the case of conventional banking.¹³⁶² A conventional bank provides funds to a borrower against specific repayment terms and collateral.¹³⁶³ The occurrence of default in such cases results in specific actions for recovery of interest and principal amount, failing which the collateral security is sold off to recover the outstanding amount owed by the borrower to the bank.¹³⁶⁴ The financing deal, in such cases is entirely transactional and involves a dispassionate, detached and arm's length relationship between the borrower and user of funds.¹³⁶⁵

Islamic banks however do not have the luxury of collateral and must share in the profits and losses of the client.¹³⁶⁶ Whilst the achievement of profits very clearly helps them in the earning of revenues and in achieving their organisational profits, the occurrence of losses can definitely result in financial setbacks.¹³⁶⁷ Islamic banks thus attempt to overcome these challenges and shortcomings by engaging in very careful scrutiny of applications requesting financial support.¹³⁶⁸ All project application and loan application are very carefully examined from the potential of viability and profitability before they are taken up for consideration.¹³⁶⁹ It is not uncommon for Islamic banks to engage in extremely detailed scrutiny of applications for funds and subjecting projects to in-depth analysis.¹³⁷⁰ Islamic bankers also aim to involve their association with borrowers through various types of contractual terms.¹³⁷¹ Whilst all contracts between borrowers and providers of funds are examined from the perspectives of fairness and equality before being taken up for consideration, they are also vetted in detail from practical perspectives, especially the potential for both profits and losses.¹³⁷²

¹³⁶¹ *Ibid*

¹³⁶² Jackson, S., *Basics of Islamic law, the sources of Islamic law*, (Ann Arbor: University of Michigan, 2004).

¹³⁶³ Iqbal, Z., & Mirakhor, A., *An introduction to Islamic finance theory and practice*, (Singapore: Wiley, 2007).

¹³⁶⁴ *Ibid*

¹³⁶⁵ *Ibid*

¹³⁶⁶ Junius, A., "Islamic finance: issues surrounding Islamic law as a choice of law under German conflict of laws principles", *Chicago Journal of international Law*, (2007): 537- 543.

¹³⁶⁷ *Ibid*

¹³⁶⁸ Kahf, M., "*Strategic Trends in the Islamic Banking and Finance movement: The Harvard forum on Islamic Finance and Banking*", (Harvard University: Boston, 2002).

¹³⁶⁹ *Ibid*

¹³⁷⁰ Kamaruddin, B. H., Safa, M. S., & Mohammed, R., "*Assessing production efficiency of Islamic banks and conventional bank Islamic windows in Malaysia*", (Munich Personal RePEc, 2008).

¹³⁷¹ *Ibid*

¹³⁷² *Ibid*

Contracts between borrowers and users of funds also often call for the sharing of wealth between bankers and customers as well as managerial responsibility.¹³⁷³ Whilst the sharing of risks, profits and losses by and large common to all Islamic financial transactions, many of them also have provisions for the sharing of management responsibility.¹³⁷⁴ Such sharing of managerial responsibility, results over time in significantly close relationships and in inputs by both bankers and users of funds on diverse areas of business operation.¹³⁷⁵ Such close involvement between borrowers and bankers results in elimination of asymmetric information, enhancement of business inputs, careful forecasting and anticipation of risks and hazards and proactive anticipatory actions, all of which help in enhancing the chances of business success, the safeguarding of loan fund and the achievement of profits, which are shared between the providers and users of funds.¹³⁷⁶

All Islamic banking contracts, be they Murabaha or Musharaka does have an element of sharing of profits and losses, which leads to a better understanding of the risks of the venture and lower pay-outs in times of losses.¹³⁷⁷ With Islamic banks obtaining deposits from their customers on similar terms and conditions, their outgo during times of economic distress is also significantly lower than in the case of conventional banking.¹³⁷⁸ All financial contracts are tested for sharing of profits, losses and risks before they can be termed to be Sharia compliant.¹³⁷⁹

The researcher feels that such an approach to financing activity is undoubtedly beneficial to both the bank and the client from perspectives of organisational security and success. There is however little doubt that such close involvement between bankers and clients is likely to become increasingly difficult and impractical with enhancement in business volumes.¹³⁸⁰ Whilst Islamic banking has certainly grown significantly over the course of the last decade (Saudi Arabia has one of the largest networks of commercial aeroplane network in the country), it is also reasonably evident that such a relationship would depend upon the rapport between the banker

¹³⁷³ Kettell, B., *Case studies in Islamic banking and finance*, (London: Routledge Publishers, 2011).

¹³⁷⁴ Kutty, F., “*Banking on Faith: Conference on Islamic Banking and Finance*”, (The Washington Report on Middle East Affairs, XIV, 40, 1995).

¹³⁷⁵ Moore, E., *The International Handbook of Islamic Banking and Finance*, (Cranbrook: Global Professional Publishing, 2009).

¹³⁷⁶ *Ibid*

¹³⁷⁷ Nyazee, I.A., “Murabaha and the credit sale”, *Advanced Legal Studies Institute, Islamic Banking Series:2*, 38, 7, (2009): 2.

¹³⁷⁸ *Ibid*

¹³⁷⁹ *Ibid*

¹³⁸⁰ Rahman, A., “Shar'ah audit for Islamic financial services: the need and challenges,” (ISRA Islamic Finance Seminar: Kuala Lumpur, 2008).

and the client.¹³⁸¹ Whilst close relationships may not be difficult to achieve as of now in the banking sector, it is impractical to assume that such relationships will remain even after banking volumes increase manifold.¹³⁸² It will become impractical and exorbitantly expensive for banks to carry on with business models that are based on close and careful oversight after substantial business growth.¹³⁸³ The writer thus feels that whilst the existing system of sharing of profits and losses does lead to risk sharing and better risk management, it is clearly impractical and even inappropriate for large volumes of business activity. Conventional banking on the other hand does not make use of such close oversight of client activity by bankers and prefers to safeguard its business through collateral security.¹³⁸⁴ This feature helps commercial banks in growing exponentially as is evident by the disproportionate growth of Islamic and conventional banking activity.¹³⁸⁵ Islamic banking comprises just about 2 to 5% of normal banking activity across the globe and it appears to be difficult for it to expand its volumes significantly with its current business model of sharing profits, losses and risks.¹³⁸⁶

8.2.3 Role of Sharia in Spread of Islamic Finance

The research carried out for this thesis reveals significant differences in the evolution of conventional commercial banking and Islamic finance.¹³⁸⁷ Conventional banking has evolved over the years, strengthened by inputs on business, trade and common law.¹³⁸⁸ Such banking is based upon the payments and receipt of interest and is essentially profit seeking in nature.¹³⁸⁹ It is devoid of any sort of religious influence, is essentially secular in nature and operates within the ambit of the commercial, civil and other laws of specific countries.¹³⁹⁰

¹³⁸¹ EIIB, “*Saudi Arabia: Gateway to Islamic Finance*”, (2015), < http://www.islamic-banking.com/resources/7/NewHorizon%20Previous%20Issues/NewHorizon_JulySep08.pdf>

¹³⁸² Ghoul, A.W., “*The Standardization Debate in Islamic Finance: A Case Study*”, (2013), < <http://conference.qfis.edu.qa/app/media/277>>

¹³⁸³ *Ibid*

¹³⁸⁴ Ariss, R., “Competitive Conditions in Islamic and Conventional Banking: A Global Perspective”, *Review of Financial Economics*, (2010): 101-108.

¹³⁸⁵ *Ibid*

¹³⁸⁶ Askari, H., Iqbal, Z., Mirakhor, A., & Krichene, N., *The Stability of Islamic Finance: Creating a Resilient Financial Environment for a Secure Future*, (John Wiley & Sons (Asia) P. Ltd. Singapore, 2010).

¹³⁸⁷ Bader, M. K. I., Mohammed, S., Ario, M., & Hassan, T., “Cost, revenue and efficiency of Islamic versus conventional banks: inter-national evidence using DEA”, *Islamic Economic Studies*, 15, 2, (2008): 23-76.

¹³⁸⁸ *Ibid*

¹³⁸⁹ *Ibid*

¹³⁹⁰ *Ibid*

Conventional banking activity is essentially a business operation and is subject to the vagaries and uncertainties of general business and economic activity.¹³⁹¹ There is little doubt that such banking activity is subject to numerous risks in terms of perpetration of frauds and unethical dealings by both insiders and outsiders, which, when detected are dealt with in terms of the common and criminal laws for the geographies in which they take place.¹³⁹² The conventional banking industry is furthermore monitored and supervised by the Central Bank, the government and other regulatory mechanisms that are in place in different geographies.¹³⁹³ It can thus be concluded that whilst commercial banking in the conventional western is primarily an interest based profit seeking financial intermediation activity between providers and users of funds and is essentially peculiar in nature and devoid of any sort of religious influence, it is governed by a complex mechanism of common law and various regulatory mechanisms. All conventional banks must operate within this broad framework of law and existing regulation. All conventional banks are furthermore governed and monitored by the central bank. The occurrence of the financial crisis of 2008 has exposed numerous areas of inadequacies, risks and regulatory insufficiencies, which in turn has resulted in the development of several severe regulatory restrictions in terms of Basel III and diverse legislations enacted in the USA, the UK and the European Union. All conventional banks, whilst they operate in a market economy and aim to achieve profits for their shareholders through various acts of financial intermediation are subject to a plethora of rules and regulations that have to be complied with and adhered to in full measure.¹³⁹⁴ There is little doubt that conventional banks, whilst being part of the free market economy are controlled and supervised closely by a complex mechanism controlled by the government and the central bank.¹³⁹⁵ These regulations closely demarcate the areas in which banks can operate, the activities in which they can engage in and the risk management method they must employ in terms of capital buffers, liquidity buffers, leverage and the like.¹³⁹⁶ These banks cannot for example engage in the financing of illegal activities like the drugs trade, the international arms trade, money laundering or activities associated with local or international

¹³⁹¹ Kamaruddin, B. H., Safa, M. S., & Mohammed, R., “Assessing production efficiency of Islamic banks and conventional bank Islamic windows in Malaysia”, (Munich Personal RePEc, 2008).

¹³⁹² *Ibid*

¹³⁹³ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

¹³⁹⁴ *Ibid*

¹³⁹⁵ *Ibid*

¹³⁹⁶ Srairi, S. A., “Cost and profit efficiency of conventional and Islamic banks in GCC countries”, *Journal of Productivity Analysis*, 34, 1, (2009): 45-62.

terrorism or crime.¹³⁹⁷ They are expected to operate with transparency, fairness and equity and can be subjected to various types of penalties if they transgress these limits.¹³⁹⁸

The occurrence of the financial crisis reveals several areas of regulatory inadequacies and loopholes that were being unfairly utilised by banks across the western nation for profit seeking purposes.¹³⁹⁹ The intense investigation that occurs in the aftermath of the crisis has resulted in the development of various new regulatory restrictions for these banks.¹⁴⁰⁰

Islamic banks on the other hand are essentially governed by the tenets of the Islamic religion, i.e. the Sharia.¹⁴⁰¹ As elaborated earlier, the Sharia also lays down several restrictions, not only in terms of the prohibition of interest and Gharar but also in the development of various types of financial products and instruments.¹⁴⁰² It is pertinent to also keep in mind that the Sharia has also evolved in different ways and various schools of Sharia thought now exists and many of these schools of thought differ in their approach towards Islamic banking and finance.¹⁴⁰³ The Islamic banking and financing sector of a particular geography is thus bound to be influenced by the prevalent Sharia school of thought.¹⁴⁰⁴ It is thus entirely conceivable that the financial products that are offered by Islamic banks in a particular geography or jurisdiction shall differ to some extent from similar one in other geography on account of differences in the Sharia approach towards such instruments in specific geographies.¹⁴⁰⁵ As elaborated earlier, different approaches of thought have different approach to the issue with regard to Musharaka being based on money or commodities.¹⁴⁰⁶ Imam Malik has opined that liquidity was certainly not a relevant condition for the validity of Musharaka.¹⁴⁰⁷ Imam Hanifa and Imam Ahmed do not allow capital of investment to be in kind, reasoning that the commodities contributed by one of the partner will always be distinguishable from the commodities provided by the other partners and result in the

¹³⁹⁷ *Ibid*

¹³⁹⁸ *Ibid*

¹³⁹⁹ Shiller, R., *The subprime solution: how today's global financial crisis happened, and what to do about it*, (Princeton: Princeton University Press, 2008).

¹⁴⁰⁰ Siddiqi, M.N., "Current Financial Crisis and Islamic Economics", *Radiance Views weekly*, 38, (2009), <<http://www.radianceweekly.com/137/3039/GLOBALMELTDOWN-Its-Viable-Alternative/2008-12-14/Cover-Story/Story-Detail/Current-FinancialCrisis-and-Islamic-Economics.html>>

¹⁴⁰¹ Forbes, "Islamic Finance Moves Toward Common Standards", (2010), <<http://www.forbes.com/2010/03/08/islam-finance-sharia-business-oxford-analytica.html>>

¹⁴⁰² Islamic Banker, "Shariah Supervisory Board", (2016), <<https://www.islamicbanker.com/education/shariah-supervisory-board>>

¹⁴⁰³ *Ibid*

¹⁴⁰⁴ *Ibid*

¹⁴⁰⁵ Islamic Banker, "Issues Relating to Musharakah", (2015), <<https://www.islamicbanker.com/education/issues-relating-to-musharakah>>

¹⁴⁰⁶ JasonKest, "Islamic Leasing Document", <<https://www.scribd.com/document/245791797/Islamic-Leasing-Document>>

¹⁴⁰⁷ *Ibid*

loss of homogeneity of capital.¹⁴⁰⁸ Imam Shafi has also devoted considerable thought to the issue and concluded the commodities when destroyed can be compensated by similar commodity with quality and quantity.¹⁴⁰⁹ Commodities like rice and wheat can be contributed as capital, whilst commodities like animal cannot be considered in the same way.¹⁴¹⁰ Disagreements have also been voiced over fixing the period of a Musharaka agreement.¹⁴¹¹ The Hanafi School of Thought feels that a person can fix the tenure of the partnership, whereas the Maliki School states that a partnership cannot be subjected to fix tenure.¹⁴¹²

The researcher feels that the existence of these different Sharia schools of thought and the different extent of their influence in different geographies represent one of the biggest challenges to contemporary Islamic financing activity, with especial regard to mortgage agreements and to the securitisation of the same. It does appear from a broad reading of available documentation that different Sharia schools of thought have quite dissimilar views on the structuring of Musharaka or Mudaraba agreements.¹⁴¹³ It becomes extremely difficult for an Islamic bank to structure a financial product that will be accepted in entirety by its customers.¹⁴¹⁴ Whilst a bank may structure a Musharaka agreement in terms of the advice provided by its Sharia board, this may be strongly contested by the Sharia board of another bank.¹⁴¹⁵ The Musharaka products on offer from different banks may thus differ significantly, making it difficult for the consumer to make a choice.¹⁴¹⁶ Saudi Arabia for instance has adopted a passive approach towards Sharia and lets its banks be governed in their action by different Sharia boards thus resulting in a plethora of products with different features.¹⁴¹⁷

Action is currently being taken in both Dubai and the UAE to develop overarching Sharia boards at the national level, which will monitor and supervise the membership of Sharia board of individual banks and thus control the financial products being offered by all the banks in the

¹⁴⁰⁸ *Ibid*

¹⁴⁰⁹ *Ibid*

¹⁴¹⁰ *Ibid*

¹⁴¹¹ Islamic Banker, “*Shariah Supervisory Board*”, (2016), <<https://www.islamicbanker.com/education/shariah-supervisory-board>>

¹⁴¹² *Ibid*

¹⁴¹³ Zulkifli, H., *Shariah Governance in Islamic Banks*, (Edinburgh: Edinburgh University Press, 2012).

¹⁴¹⁴ Edbiz Consulting, *Global Islamic Finance Report 2013*, (London: Edbiz Consulting, 2013).

¹⁴¹⁵ Basit, A., “*Call for Shariah-compliant products' standardisation*”, (2015), <<http://www.khaleejtimes.com/business/banking-finance/call-for-shariah-compliant-products-standardisation>>

¹⁴¹⁶ *Ibid*

¹⁴¹⁷ Al Rajhi Capital, “*Saudi Mortgage law: Planning for the long-term*”, (2013), <http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

state.¹⁴¹⁸ Such an overarching Sharia board is however not in place either in the UK or in Saudi Arabia,¹⁴¹⁹ with the result that Islamic financing activity in these countries is rather disjointed in nature with different products on offer from different banks.¹⁴²⁰

8.2.4 Absence of Standardisation in Islamic Finance

The previous subsections have detailed the influence of Sharia on the practice of Islamic financing. Islamic finance is very clearly dominated and shaped by the tenets of the Islamic religion.¹⁴²¹ The complete business model of Islamic banking and finance has been built upon the assumptions that Riba, i.e. interest and Gharar are prohibited.¹⁴²² With these assumptions in mind, Islamic bankers and financial experts have developed a model of financing that is rid of exploitation of the poor by the rich, the unfairness of interest and the sharing of profits, losses and risks. Islamic bankers have developed financial tools and products like the Musharaka and the Murabaha, wherein the application of interest has been totally replaced by the sharing of profits, losses and risks.¹⁴²³ Models have made for leasing of capital equipment, machinery and even working capital.¹⁴²⁴ These instruments have been on offer now for years in various Islamic countries across the world as well as in commercial banks with Islamic vendors for customers.¹⁴²⁵

The basic concept of these different financial products rests upon the sharing of profits, losses and risks by individual banks and their clients, rather than the payment and receipt of interest by two parties, i.e. the user and supplier of funds.¹⁴²⁶ The Islamic finance industry has grown steadily, primarily in Islamic countries across the world in the last two decades.¹⁴²⁷ It is also gaining traction in the UK and other West European nations. The Islamic finance sector, despite its acceptance by various geographies is still only 2 to 5% of total global financial and

¹⁴¹⁸ Ghoul, A.W., “*The Standardization Debate in Islamic Finance: A Case Study*”, (2013), <<http://conference.qfis.edu.qa/app/media/277>>

¹⁴¹⁹ *Ibid*

¹⁴²⁰ Ali, J.I., “*Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws*”, (2013), <http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹⁴²¹ The European, “*Islamic Finance: An expert analysis*”, (2014), <<http://www.the-european.eu/story-8395/islamic-finance-expert-analysis.html>>

¹⁴²² *Ibid*

¹⁴²³ *Ibid*

¹⁴²⁴ Wilson, R., *Legal, regulatory and governance issues in Islamic finance*, (Edinburgh: Edinburgh University Press, 2012).

¹⁴²⁵ *Ibid*

¹⁴²⁶ Visser, H., *Islamic finance: principles and practice*, (London: Routledge Publishers, 2013).

¹⁴²⁷ *Ibid*

banking activity.¹⁴²⁸ Several experts have stated that Islamic finance, with its particular features, namely the prohibition of interest, the elimination of Gharar, the sharing of profits, losses and risks and its positive socioeconomic approach should have grown much faster than it has done until now.¹⁴²⁹ Several financial experts have argued that Islamic finance activity would have grown much faster than it has until now if its products had been characterised by greater standardisation.¹⁴³⁰ As explained earlier, Islam is characterised by the fragmentation of religion across geographical lines and different schools of religious thought.¹⁴³¹ The Sharia has laid down specific principles and approaches about the structuring and development of Islamic financing activity.¹⁴³² Whilst the Sharia is provided with great respect across the world its authority is diluted by significant differences of opinion on various religious matters, including Islamic banking amongst different Sharia experts.¹⁴³³

The Sharia experts of different geographies have interpreted the Quran on their own and come to several contradictory conclusions on the structuring of financial products.¹⁴³⁴ Islamic financing models have thus evolved somewhat differently in states, influenced by local Sharia experts.¹⁴³⁵ It would also not been wrong to state that serious differences in interpretation of religious texts exist amongst Sharia experts within a country.¹⁴³⁶ The Sharia board of a particular bank may have very different attitudes towards products like the Musharaka and Murabaha from other Islamic banks in the same city or nation.¹⁴³⁷ Such lack of standardisation amongst the financial products of Islamic banks is acknowledged to be one of the most important barriers to the spread of Islamic banking activity across the world.¹⁴³⁸

Several experts have stated that customers tend to get confused when they compare the financial products that are made available by different banks.¹⁴³⁹ Several banking experts have furthermore reiterated that harmonisation of the financial product available with different banks

¹⁴²⁸ *Ibid*

¹⁴²⁹ Usmani, M.T., *An introduction to Islamic finance*, (London: Brill Publishers, 2012).

¹⁴³⁰ *Ibid*

¹⁴³¹ Vayanos, P., Wackerbeck, P., Golder, P., & Haimari, G., “*Competing successfully in Islamic Banking*”, (2014), <<http://www.strategyand.pwc.com/media/file/Competing-Successfull-Islamic-Banking.pdf>>

¹⁴³² *Ibid*

¹⁴³³ *Ibid*

¹⁴³⁴ Susan, F., “The efficiency of Islamic banking industry: a non-parametric analysis with non-discretionary input variable”, *Islamic Economic Studies*, 14, 1&2, (2006): 54-87.

¹⁴³⁵ *Ibid*

¹⁴³⁶ Sole, J., *Introducing Islamic banks into conventional banking systems*, (Oxford: Oxford University Press, 2007).

¹⁴³⁷ *Ibid*

¹⁴³⁸ *Ibid*

¹⁴³⁹ Siddiqi, M. A., “Banking on Shariah Principles: Islamic Banking Has Witnessed Remarkable Growth from Its Humble Beginnings in the Early 1970s into a 21st Century Multi-Billion Dollar Global Niche Industry”, *The Middle East*, 24, (2002): 1-5.

would help in enhancing a credibility of Islamic financial products, simplify transactions and attract more customers.¹⁴⁴⁰ Such lack of standardisation has also been attributed to the absence of an overarching standard setting body both at the national and the international level.¹⁴⁴¹ The continuing differences of opinion amongst Sharia experts and the absence of coordinating bodies is perpetuating the absence of standardisation and retarding the spread of Islamic finance in geographies other than purely Islamic nations.¹⁴⁴² The research for this project revealed that some states like the UAE are taking concrete steps to put Sharia boards in place at the national level with responsibilities of monitoring the actions of the Sharia boards of individual bank.¹⁴⁴³ Such efforts will certainly help in bringing about standardisation of products within particular geographies and develop an environment for the establishment of an international standard setting board.¹⁴⁴⁴

8.2.5 Legislation in the UK, Sharjah, Dubai and Saudi Arabia

The spread of Islamic finance has resulted in the development of several challenges for regulators in the banking sector across the world.¹⁴⁴⁵ Whilst regulators previously have to monitor and supervise the activities of secular, profit seeking establishment engaged in financial intermediation, they now have to supervise and monitor the activities of banking organisation that operated under very different religious philosophy.¹⁴⁴⁶ Different states have reacted to this challenge in different ways as elaborated below.

The UK currently operates a non-discriminatory regime, wherein Islamic financial institutions are required to obtain banking licenses; their transactions are furthermore determined by English law.¹⁴⁴⁷ They are required to operate within the principles of good regulation laid out within the SFMA, which aims to encourage innovation and avoid the implementation of unnecessary barriers to expansion for entry within the financial market.¹⁴⁴⁸ The UK government has also been proactive in its aims to encourage the spread of Islamic banking and has removed

¹⁴⁴⁰ *Ibid*

¹⁴⁴¹ *Ibid*

¹⁴⁴² Schoon, N., *Islamic banking and finance*, (London: Spiramus press Ltd, 2009).

¹⁴⁴³ Gill, R., "THE NEW UAE MORTGAGE REGULATIONS", (2014), < <http://www.tamimi.com/en/magazine/law-update/section-8/december-january-1/the-new-uae-mortgage-regulations.html>>

¹⁴⁴⁴ Schoon, N., *Islamic banking and finance*, (London: Spiramus press Ltd, 2009).

¹⁴⁴⁵ Agha, O., "Islamic finance dispute resolution", *Leading Lawyers*: (2009) pp. 2.

¹⁴⁴⁶ Ahmed, P., "How Islamic Finance Can Deal with Modern Day Challenges", *Islamic Horizons*, 39, (2010): pp. 36-45.

¹⁴⁴⁷ Ahmad, W., "*Islamic banking in the United Kingdom: Opportunities and Challenges*", (2008),

<<https://www.alislam.org/library/articles/Islamic-Banking-in-the-UK.pdf>>

¹⁴⁴⁸ *Ibid*

double taxation for Islamic mortgages.¹⁴⁴⁹ The stamp duty of an Islamic mortgage which passes through two sets of buyers and sellers now have to be paid only once.¹⁴⁵⁰ Confusion has also arisen in the past over a savings account which has traditionally been considered to be a deposit but is in fact a Mudaraba or profit and loss sharing account, wherein a customer was exposed to the risk of losing his or her capital on account of bank performance.¹⁴⁵¹ The UK government has also highlighted the role of the Sharia supervisory board with regard to ensuring that the financial products offered by Islamic financial institution are Sharia compliant.¹⁴⁵² A note of concern is however been expressed by specific expert who have found that only a small portion of Islamic financial products are truly Sharia compliant; this shortcoming may be due to the fact that a system for standardised education for scholars of Islamic law does not exist at present.¹⁴⁵³ With there being no plans for the development of a central Sharia committee in the UK in the near future, confusion over Sharia compliant is likely to continue.¹⁴⁵⁴

The UAE has put detailed legislation in place for Islamic banks through Federal Law no 6. Such Islamic institutions in the UAE are required to apply Islamic Sharia law in their articles and memorandums of association and conduct their operation on accordance with Islamic Sharia law.¹⁴⁵⁵ They are required to adopt a public joint stock company structure and obtain operating licenses from the central bank.¹⁴⁵⁶ They are also required to establish Sharia committees of three or more people who are required to be approached by the supervisory Sharia committee within the appropriate ministry.¹⁴⁵⁷ The UAE government has also put in place specific rules and regulation for the use of various financial products like the Musharaka, the Mudaraba, the Ijara and others.¹⁴⁵⁸

Saudi Arabia on the other hand recently introduced mortgage legislation in the form of 6 laws to encourage mortgaging and real estate activity in the country.¹⁴⁵⁹ The country places

¹⁴⁴⁹ *Ibid*

¹⁴⁵⁰ Ainley, M., Mashayekhi, A., Hicks, R., Rahman, A., & Ravalia, A., “*Islamic finance in the UK: regulation and challenges*”, (2007), <<http://media4.efinancialnews.com/share/media/downloads/2007/11/2349281881.pdf>>

¹⁴⁵¹ *Ibid*

¹⁴⁵² *Ibid*

¹⁴⁵³ *Ibid*

¹⁴⁵⁴ *Ibid*

¹⁴⁵⁵ Mayankar, S.S., “*Standardisation required to promote Islamic finance in UAE*”. (2014), <<http://gulfnews.com/business/sectors/banking/standardisation-required-to-promote-islamic-finance-in-uae-1.1405665>>

¹⁴⁵⁶ *Ibid*

¹⁴⁵⁷ Al Tamimi & Company, “*Islamic Finance A UAE Legal Perspective*”, (2015), <<http://web.dubaichamber.ae/LibPublic/Islamic%20finance%20a%20UAE%20legal%20perspective.pdf>>

¹⁴⁵⁸ *Ibid*

¹⁴⁵⁹ Ali, J.I., “*Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws*”, (2013), <http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

Islamic banks on par with other commercial banks and ensures that all banks are treated in the same way.¹⁴⁶⁰ Most of the Islamic in Saudi Arabia use the principles of Musharaka, Mudaraba, Ijara and Qard Hasan.¹⁴⁶¹ The achievement of complete compliance with Sharia is required in both financial and non-financial transactions.¹⁴⁶² The country is engaged in a concerted effort to ensure that all financial institutions set up Sharia boards to ensure complete compliance even though they do not exist at present.¹⁴⁶³ The Sharia governance system in the country is thus a product of self-initiative rather than regulation by a prescribed authority.¹⁴⁶⁴

8.3 Impact and Implications of Islamic Mortgages

This research study specifically aimed to examine the ways in which Islamic banking procedures could be altered and modified to bring about higher levels of standardisation and harmonisation, as well as Sharia compliance. The research study specifically focused on Islamic mortgaging laws and how they could be modified or altered to bring about greater benefits for society and market expansion. The research firstly revealed that Islamic banking practices currently suffered, with regard to both customer acceptance and growth on account of the lack of standardisation in the products offered in different geographies and even by different banks in the same geography, primarily on account of different religious interpretation of Islamic law by different experts.¹⁴⁶⁵ Such differences in religious interpretation have in fact been the primary driver of the lack of standardisation that exists in current Islamic mortgaging procedures and continue to affect standardisation even today.¹⁴⁶⁶

There is little doubt that whilst Islamic banking, in its present form is a comparatively recent phenomenon and commenced just a few decades ago, it has, in this short period of time expanded enormously and has become an important banking channel for bank customers in

¹⁴⁶⁰ *Ibid*

¹⁴⁶¹ Deloitte, “*Saudi mortgage laws A formula for a well-functioning market?*”, (2013), <https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹⁴⁶² *Ibid*

¹⁴⁶³ Oxford Business Group, “*Saudi Arabia's new mortgage law*”, (2016), <<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁴⁶⁴ *Ibid*

¹⁴⁶⁵ Aldohni, A.K., *The legal and regulatory aspects of Islamic banking*, (London: Routledge Publishers, 2012).

¹⁴⁶⁶ Amin, A., “*How industry standardisation in Islamic finance could help promote cross-border transactions*”, (2012), <http://www.mohammedamin.com/Islamic_finance/Industry-standardisation-and-cross-border-Islamic-finance.html>

several countries.¹⁴⁶⁷ It has grown substantially, especially in countries with large Muslim populations, in the MENA region, as also in Asian countries like Pakistan, Malaysia and Indonesia.¹⁴⁶⁸ The UK has become the European hub of Islamic banking and several conventional banks and a few Islamic banks offer various types of Islamic banking products including mortgages. The lack of standardisation amongst the products offered by different banks has however resulted in sluggish growth in products off take and many potential Islamic mortgage consumers continue to make use of conventional mortgages for the satisfaction of their house mortgage needs.¹⁴⁶⁹ The research however revealed that efforts are continuing, primarily at the level of policy makers to develop specific measures for ensuring of standardisation, harmonisation and Sharia compliance of the products offered by different banks.¹⁴⁷⁰ Most of these involve the development and appointment of specific boards that can ensure Sharia compliance amongst Islamic banks in specific geographies.¹⁴⁷¹ Countries like Saudi Arabia, have also formulated new laws for facilitating the off take of mortgage activity.¹⁴⁷² It is important to keep in mind that whilst such measures will help in enhancing Islamic mortgaging activity in future, much will depend upon cross coordination between the Islamic banking authorities and policy makers of different countries.¹⁴⁷³ With globalisation becoming stronger with every passing year, there are reasons to hope that Islamic banking and mortgaging activity will expand and become stronger over the years.¹⁴⁷⁴

¹⁴⁶⁷ Khan, M. M., & Bhatti, M. I., "Development in Islamic banking: a financial risk-allocation approach", *The Journal of Risk Finance*, 9, 1, (2008): 40-51.

¹⁴⁶⁸ Lewis, M.K., "In what ways does Islamic banking differ from conventional finance?", *Journal of Islamic Economics, Banking and Finance*, 4, 3 (2008): 4-6.

¹⁴⁶⁹ Usmani, M.T., *An introduction to Islamic finance*, (London: Brill Publishers, 2012).

¹⁴⁷⁰ Aldohni, A.K., *The legal and regulatory aspects of Islamic banking*, (London: Routledge Publishers, 2012).

¹⁴⁷¹ Ercanbrack, J., "The regulation of Islamic finance in the United Kingdom", *Ecclesiastical Law Journal*, 13, 1, (2011): 69-77.

¹⁴⁷² Ali, J.I., "Kingdom of Saudi Arabia – New Mortgage, Real Estate and Financing Laws", (2013), <http://www.kslaw.com/library/publication/measure_Winter2013.pdf>

¹⁴⁷³ Amin, A., "How industry standardisation in Islamic finance could help promote cross-border transactions", (2012), <http://www.mohammedamin.com/Islamic_finance/Industry-standardisation-and-cross-border-Islamic-finance.html>

¹⁴⁷⁴ Usmani, M.T., *An introduction to Islamic finance*, (London: Brill Publishers, 2012).

Chapter 7: Conclusions and Recommendations

9.1 Introduction

This research project has entailed the investigation and study of various aspects of Islamic finance with particular regard to mortgaging, leasing and securitisation activity. The investigation of the study was carried out with the help of a detailed review of literature, the use of an interpretivist / qualitative approach to research and the examination of four case studies pertaining to the practising of Islamic finance and the provisioning of Islamic mortgages in the UK, Saudi Arabia, Sharjah and Dubai.

The research has revealed that whilst Islamic banking is growing steadily, especially in Islamic countries. The process is suffering on account of confusion in the application of Sharia principle and a specific lack of standardisation in the financial products on offer. This section contains recommendations on measures that can be taken by Saudi Arabia to improve the spread of Islamic finance and mortgaging and securitisation activity in the country.¹⁴⁷⁵

9.2 Recommendations

This thesis recommends measures that can be taken by Saudi Arabia to encourage mortgaging activity in the country. The research revealed that whilst Islamic finance is increasing steadily in Saudi Arabia, the area suffers from an absolute lack of standardisation and a passive approach towards the issue. Very few of the Islamic banks and financial institutions have Sharia committees in place and the country does not have a national Sharia committee for guiding the work of different Sharia boards in different banks.¹⁴⁷⁶ Whilst Saudi Arabia has enacted a number of laws to promote and encourage mortgaging activity, much more needs to be done in the regulation of Islamic finance to reap the benefits of these legal changes.¹⁴⁷⁷

The approach towards Sharia compliance at present is totally by way of self-initiative, like in the case of Al Rajhi, and the Islamic bank by and large do not have standardised mortgage products on offer.¹⁴⁷⁸ Such absence of standardisation very obviously makes securitisation far

¹⁴⁷⁵ *Ibid*

¹⁴⁷⁶ Al Rajhi Capital, “*Saudi Mortgage law: Planning for the long-term*”, (2013), < http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

¹⁴⁷⁷ Oxford Business Group, “*Saudi Arabia's new mortgage law*”, (2016), <<https://www.oxfordbusinessgroup.com/analysis/legislative-change-new-mortgage-law-formalises-real-estate-lending>>

¹⁴⁷⁸ *Ibid*

more difficult that it would otherwise has been.¹⁴⁷⁹ It is thus recommended that initiatives should be taken at the national level, (1) to install Sharia committee in all the banks, (2) to establish a national Sharia committee, (3) to ensure that the Sharia committee of individual banks work in tandem with each other and (4) to achieve high levels of standardisation in the mortgage products on offer. Such a concerted effort at standardisation will have numerous benefits.¹⁴⁸⁰ The actions of various Sharia committees and the national Sharia committee will bring about high levels of coordination and Sharia compliance amongst the banks.¹⁴⁸¹ The standardisation of mortgage products on offer will definitely attract more customers, result in greater numbers of mortgages and develop an environment for securitisation.¹⁴⁸²

Standardisation along with a harmonised approach to Sharia compliant will also result in greater demand for Sharia compliant mortgages, greater competition and the development of new but standard Sharia complaint products.¹⁴⁸³ This in turn should result in the reduction of prices and far greater activity in the mortgage market in Saudi Arabia.¹⁴⁸⁴ The research also revealed that Sharia compliance was inadequate in the products of Islamic banking and the Islamic departments of conventional banks in the UK. This lack of compliance essentially stemmed from differences in opinion of different Sharia experts and created confusion amongst customers. It was thus essential for the Islamic banking fraternity in the UK to establish a superior Sharia authority to oversee the Sharia compliance in UK Islamic banks. This in fact would go a long way towards standardisation and assist in the development of Sharia complaint and standardised product. It would also be necessary for UK Islamic banks to bridge the gap between Islamic law and conventional banking practices through the appropriate usage of definitions, policies and processes.

The situation in the UAE was the most intriguing because the country adhered to common law. Whilst professedly Islamic in nature, it did not ban interest, the consumption of pork or engagement in entertainment. Islamic banks were expected to provide several types of products but ensure that they adhered to the tenets of common law. Standardisation was also

¹⁴⁷⁹ Deloitte, “*Saudi mortgage laws A formula for a well-functioning market?*”, (2013), < https://www2.deloitte.com/content/dam/Deloitte/xs/Documents/realestate/me_real_estate_mortgage_whitepaper_072013.pdf>

¹⁴⁸⁰ *Ibid*

¹⁴⁸¹ Al Rajhi Capital, “*Saudi Mortgage law: Planning for the long-term*”, (2013), < http://www.alrajhi-capital.com/en/research/Market/Mortgage%20law_Mar%202013_Final.pdf>

¹⁴⁸² *Ibid*

¹⁴⁸³ Ghoul, A.W., “*The Standardization Debate in Islamic Finance: A Case Study*”, (2013), < <http://conference.qfis.edu.qa/app/media/277>>

¹⁴⁸⁴ *Ibid*

being brought in through the actions of a superior Sharia authority. The only barrier in the UAE stemmed from the continuance of some differences between common law and the Sharia. These differences will have to be bridged in order to ensure steady progress of Islamic banking and mortgaging in the coming years.

The adoption of the following recommendations should help in enhancement of standardisation, harmonisation and Sharia compliance of Islamic banking and enhance its expansion.

- Policy makers and Islamic banking authorities should try to arrive at common ground on Sharia tenets with regard to Islamic banking activity in different countries.
- Islamic banking is prevalent in specific countries in the MENA region, Asia and primarily in the UK in Europe. Efforts should be made to develop an international body on Islamic banking, possibly under the aegis of the United Nations.
- This body should comprise of experts from different countries on the Sharia, as well as Islamic and conventional banking. This committee should be formed on the lines of the International Accounting Standards Board (IASB) and have a specific mandate for bringing about harmonisation and standardisation between the Islamic banking tenets of different countries. This committee should have specific objectives and work in accordance with a definite time frame, like the one adopted by IASB to bring about standardisation in accounting standards.
- There is little doubt that such standardisation will not be possible within the short term. A practical view should be taken of the matter and the committee should be provided with a realistic time frame, say 5 to 7 years to arrive at specific conclusions, recommendations and directives.
- Broad agreement should be obtained by all countries, engaged in Islamic banking to abide by the decisions and directives of the committee.
- The decisions on standardisation and harmonisation should thereafter be introduced in a phased manner in all the countries, with a specific deadline, i.e. 10 years from the formation of the committee.

- The adoption of these recommendations should help and facilitate the development of harmonised and standardised Islamic banking procedures that are Sharia compliant within a specific time period of 10 years. It will be necessary for Islamic banking decision makers, religious heads and policy makers to work closely and in collaboration with each other to ensure success in the achievement of these objectives.

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