ISLAMIC FINANCE: DEVELOPMENTS AND OUTLOOK

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Islamic finance encompasses instruments and institutions governed by Islamic law or the Shari'ah, which implies that most assets take the form of contracts linked to an underlying asset. In recent years, Islamic finance has grown significantly, outpacing conventional finance, driven by the rise of emerging economies with Islamic jurisdictions, its gradual internationalisation, and the rising demand among the Muslim population worldwide, which has very low rates of access to and use of bank services. The future development of Islamic finance will require qualitative changes in terms of aligning its regulatory and supervisory standards to the reference Basel regulatory framework.

Introduction

Islamic finance includes all financial institutions and instruments that comply with the precepts of the Shari'ah or Islamic law, which establishes three main requirements for financial transactions: they should be free of interest (riba), based on real assets, and should not fund activities considered to be harmful (haram), such as gambling or the production and sale of alcohol or pork products. The Shari'ah law also establishes a set of principles, such as the prohibition of excessive risk-taking *(gharar)* or speculation *(masyr),* or the requirement that transactions are based on fair prices, entail no risk and include the right to equal and appropriate information and cooperation between contracting parties.

Over the past decade, Islamic finance has expanded notably, posting double-digit rates, diversifying products and institutions and gradually gaining market penetration internationally. Currently, the Islamic financial sector is no longer confined to the Muslim population and is present in "secular" countries, including in several European Union countries. However, its future poses a series of challenges, particularly in terms of regulatory heterogeneity and adaptation to the regulatory framework of conventional financial jurisdictions. This article addresses the main features of Islamic finance, its recent developments and current situation, and the regulatory challenges ahead.

Main features of Islamic finance

Subject to the general requirements and principles described in the introduction, the design and configuration of specific Islamic finance instruments provide for a certain degree of discretion, depending on the jurisdiction. The biggest component of the Islamic finance sector is banking (close to 80% of total Islamic financial assets), followed by the Islamic bond or *sukuk*, which accounts for 16%. Islamic banking instruments largely take the form of contracts linked to an underlying asset, generally goods, services or shares. There are two main types of contracts: those based on purchase and sale transactions with a mark-up, mostly used for short and medium term financing; and those based on a profit-and-loss sharing structure in which the bank bears part of the transaction risk. Financial gains (which are permitted provided that they do not take the form of interest) are linked to the value of the underlying asset. Table 1 summarises the main instruments for each of these groups.

On the liabilities side (see Table 2), the "deposits" take the form of investment accounts, where profitability is determined *ex post* depending on the bank's profitability or that of the specific underlying assets (usually *mudarabah* contracts). These accounts may be

KEY INSTRUMENTS OF ISLAMIC FINANCE

TABLE 1

Mark-up contracts. «Loans» take the form of asset purchase transactions by the financial institution and resale/leasing of assets to the customer, on the basis of deferred payment	
Murabah	The bank purchases the asset at the request of the customer, and resells it to the latter at a mark-up and with deferred payment. The contract establishes the price and the form of payment, whether deferred over a period of time or in a single bullet payment. Any losses are borne by the capital provider (the bank), not the entrepreneur (unless the latter's negligence can be proved).
Salam	The buyer (bank) makes a spot payment, under the promise of receiving specific goods from the seller (customer) at a future date (deferred delivery). Mainly used in agricultural financing.
Istisna	Similar to salam,this is a contract in which an asset can be purchased before it comes into existence, with an obligation on the part of the customer to manufacture and deliver it at a future date. It is used in long-term project financing.
Ijarah	Leasing of a tangible asset or services for a specified period, with a right to purchase (similar to leasing in conventional banking). The owner of the asset (the bank) bears the full risk associated with ownership.
Profit-and-loss sharing contracts, in which the bank bears part of the risk	
Mudarabah	The bank contributes capital for the project and the other party contributes the work. Profits are shared, but losses are borne entirely by the lender (the bank or investor) and not by the entrepreneur (unless the latter's negligence can be proved).
Musharakah	Contract of joint partnership, in which both profits and losses are shared. Both parties provide capital to finance the project.

SOURCE: Banco de España, based on International Monetary Fund (2015b).

BALANCE SHEET OF AN ISLAMIC BANK

TABLE 2

ASSETS	LIABILITIES
Asset financing *(murabah, salam, ijarah, istisna)*	Demand deposits *(wadia* or *amanah)*
Asset investment *(mudarabah, musharakah)*	Investment accounts *(mudarabah)*
Fees (for services provided)	Special investment accounts *(mudarabah, musharakah)*
	Equity
	Reserves

SOURCE: Banco de España, based on Ascari *et al.* (2015).

restricted or unrestricted, depending on whether the bank has limitations on the type of investment it can make with the deposit-holder's funds. The liabilities side also includes interest-free current accounts, for which the bank acts solely as a custodian or safekeeper, returning 100% of the deposit *(wadiah o amanah),*[1] and conventional capital instruments.

Unlike conventional bonds which are debt instruments, the *sukuk* represents partial ownership of a share, a real asset or a service (bringing it closer to asset-backed securities, ABS).[2] The principal is not usually guaranteed, and profitability is determined on the basis of the profitability of the underlying asset. *Sukuk* bonds can adopt the same structures as those of Islamic banking instruments, including receivables *(sukuk al murabah),* leasing *(ijarah),* construction project *(istisna),* deferred delivery of assets *(salam)* or investments *(mudarabah, musharakah).*

1 Under the wadiah contract, the deposit is based on trust, and the amount deposited may be used provided there is no intention of obtaining profits. Under the amanah contract, however, the deposit cannot be used, and the bank's activity is limited to custody and safekeeping.

2 In respect of sukuk bonds, the investor may have a claim to the underlying asset itself (asset-backed) or recourse to the originator of the asset (asset-based).

With respect to the insurance sector, the *takaful* is the Islamic instrument which most resembles conventional insurance instruments, specifically those of mutual or cooperative insurance companies. However, unlike conventional insurance, the *takaful* policy holder shares the profits and losses of the business, and all the assets and investments managed by the Islamic insurance company must conform to Shari'ah precepts. The Islamic finance sector has other instruments such as Islamic investment funds, Islamic equity indices, such as the *Dow Jones Islamic Market Index* (DJIM) or Islamic microfinance based on a cooperative model.

Islamic finance market developments

In recent years, the Islamic finance sector has grown rapidly, by almost 11.5 % between 2010 and 2015, while the conventional financial system grew by 3.2 % between 2010 and 2014.[3] At end-2015, the sector was valued at $1.88 trillion,[4] accounting for nearly 1% of total financial assets worldwide (IFSB [2015 and 2016]).[5] This growth was largely underpinned by the accumulation of wealth of oil-exporting countries and the growth of capital markets in the Persian Gulf and Southeast Asia. In 2015, some slowdown was observed, owing to the fall in hydrocarbon prices and the lower growth of emerging markets, and to the exchange rate depreciation in jurisdictions with a large Islamic finance presence, including Iran, Malaysia, Turkey and Indonesia.

In addition to these short-term economic factors, growth of Islamic finance has also been driven by structural factors, which will no doubt continue to apply and provide sustained momentum. Firstly, the potential rise in demand for financial services by a Muslim population with still-low rates of access to and use of bank services. Currently, around 76% of the adult Muslim population do not have a bank account and 93% have no access to formal financing, as compared with 56% and 91%, respectively, of the non-Muslim population (population (Demirgüç-Kunt *et al.* [2013]). Further, it is estimated that the Muslim population will grow by 73% between 2010 and 2050, compared with 35% projected for the world population (Pew Research Center [2015]).

Secondly, another factor boosting Islamic finance is public-sector support for the promotion and development of Shari'ah-compliant markets and products. Thus, several national authorities in both Muslim and secular countries have been gradually adapting their legislation to enable the inclusion of Islamic finance instruments. Internationally, new organisations have been formed to promote the standardisation and regulation of Islamic financial instruments, such as the Islamic Financial Services Board (IFSB, in 2002) or the International Islamic Financial Market (IIFM, also in 2002). Also, institutions such as the International Monetary Fund, the World Bank, the Islamic Development Bank or the G20, have promoted seminars and studies to foster knowledge, access and integration of this type of instruments in the international financial system.

By geographical area, the largest proportion of Islamic financial assets are to be found in the Gulf Cooperation Council (GCC) countries (39%) and in the Middle East and North Africa (MENA) region (33%) (IFSB [2016]). By country, Iran (37%), Saudi Arabia (19%) and Malaysia (9%) are the top three in terms of the percentage of global Islamic banking assets. In recent years, Islamic finance has grown considerably in countries such as Bangladesh,

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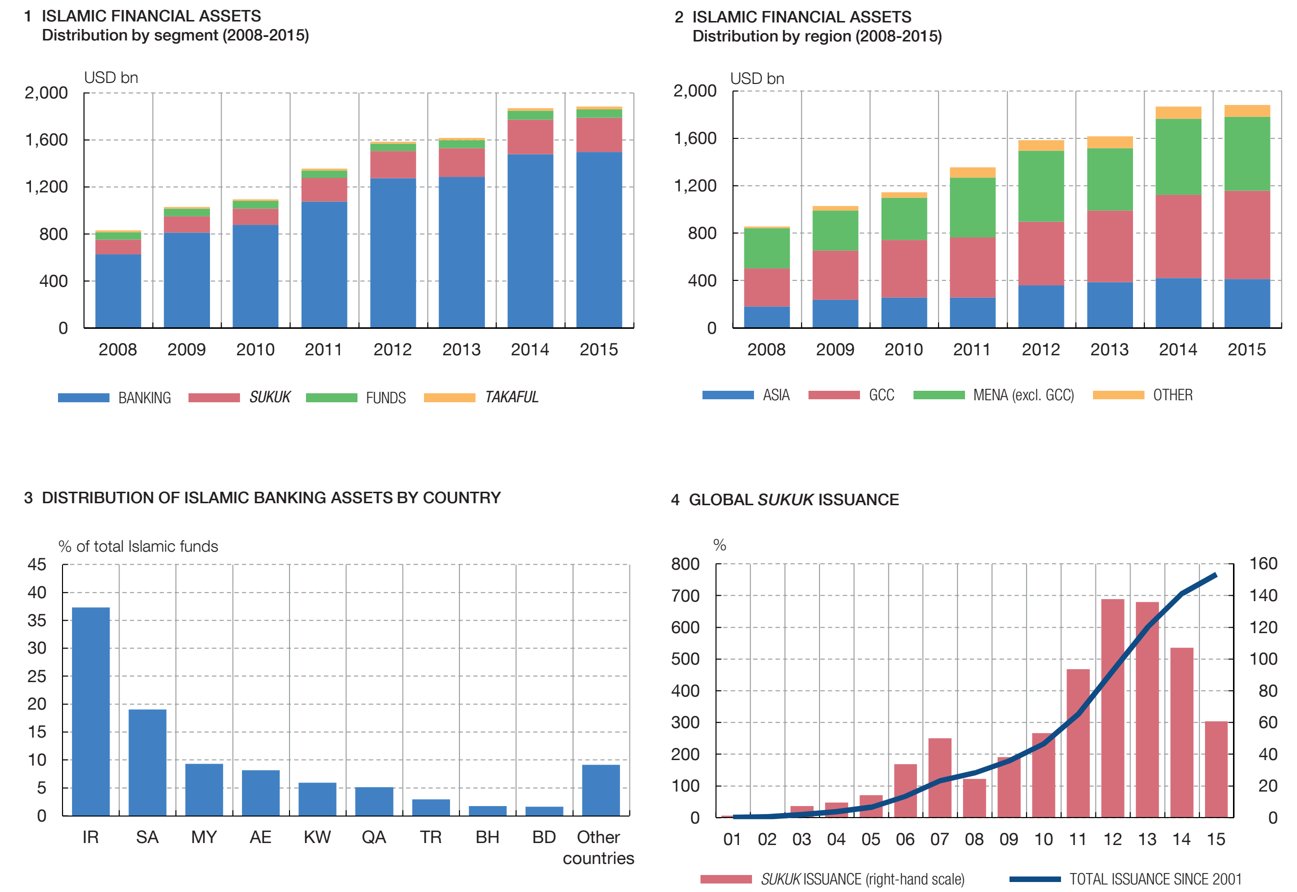
3 Estimate based on the sum of assets of banks and other financial intermediaries relating to 26 jurisdictions (Financial Stability Board, FSB [2015]).

4 Approximate estimate (may include duplication) of the total value of managed assets, measured as the sum of banking sector assets, Islamic funds and the value of outstanding sukuk issues and takaful contributions (IFSB [2016]).

5 García-Herrero *et al.* (2008) analyse developments in Islamic finance since its beginnings in the 1960's.

ISLAMIC FINANCIAL ASSETS

CHART 1



SOURCES: Islamic Financial Services Board, International Monetary Fund, International Islamic Financial Market and Banco de España.

Turkey, Jordan, Bahrain and Pakistan, with public-sector support aimed at developing this sector and adapting its regulations. In Europe,[6] the United Kingdom is the chief secular centre for Islamic finance, ranking ninth by volume of Islamic assets worldwide.

The degree of penetration in the financial sector overall varies depending on the jurisdiction. In countries such as Iran and Sudan, Islamic finance assets account for 100% (all banking assets are Shari'ah-compliant), and in a further 10 jurisdictions (Brunei, Saudi Arabia, Kuwait, Yemen, Qatar, Malaysia, Bangladesh, Bahrain, United Arab Emirates and Djibouti) Islamic finance is systemically important, accounting for more than 15% of total bank assets. However, in other countries (such as Egypt, Turkey or Indonesia), the degree of penetration is much lower (around 5%). Islamic finance is still in the very early stages of development in the European Union, although it has gradually gained importance in the United Kingdom and Luxembourg,[7] and in other financial centres such as Switzerland, Hong Kong and the United States.

By sector, banking dominates the Islamic finance sector, accounting for almost 80% of the total. During the 2010-2015 period, average annual growth stood at 11.3 % (IFSB [2016]), substantially higher than that of conventional banking worldwide (around 3% in 2010-2014)

6 For more information on Islamic finance in Europe, see Benali (2015).

7 Retail banking seems to have come to a standstill, following some initial timid attempts in the 1990's (Anca [2014]). However, the sukuk market and Islamic funds have experienced stronger growth, especially in these two countries.

(Financial Stability Board, FSB [2015]). The *sukuk* market experienced equally strong growth (15.7% in 2010-2015), with an issuance volume which rose from $7 billion in 2003 to as much as $137 billion in 2012 (IIFM [2016]). This upward trend was gradually reversed, notably in 2015, with a fall of 43% in issuance, owing largely to the Malaysian Central Bank's decision to end its short-term *sukuk* issuance programme.[8] In 2015, the outstanding balance represented 0.35% of the global bond market. By issuer, the volume of outstanding issues is distributed in practically equal proportions between sovereign issuers and private firms, while by country, a large proportion is concentrated in three jurisdictions: Malaysia (with almost 57% of the outstanding balance), Saudi Arabia (16%) and United Arab Emirates (10%). The United Kingdom was the first non-Islamic country to issue *sukuk* bonds for a value of £200 million in 2014 (the Federal State of Saxony had done so earlier, in 2005), subsequently followed by countries such as Luxembourg, South Africa, Hong Kong or Senegal. As regards currency, most *sukuk* bonds are issued in the Malaysian ringgit (64%), followed by the US dollar (18%) and the Saudi Arabian riyal (4.7%).

Lastly, note should be taken of the growth of Islamic investment funds, which went from managing assets valued at $29 billion in 2004 to more than $75 billion at end-2014, their activity mainly concentrated on shares (36%) and money markets[9] (35%),[10].[11] These funds were initially set up in Saudi Arabia and GCC countries and later spread to other countries, including non-Muslim ones, which accumulate almost 40% of funds and 30% of investments. Europe, Luxembourg and Ireland[12] are major centres operating with Islamic funds, representing 20% and 4%, respectively, of the Islamic fund market outside Islamic countries.

Regulatory challenges posed by Islamic finance

The rapid growth and internationalisation of Islamic finance poses regulatory and supervisory challenges on two main fronts: on the one hand, the need to harmonise Islamic finance regulatory standards and, on the other, bringing them into line with those of conventional jurisdictions, where the additional problem of double or multiple taxation arises.[13]

On the regulatory front, Islamic finance is highly heterogeneous as a result of the discretionary interpretation of the Shari'ah, which depends on each jurisdiction. This hampers growth of the sector and prevents effective integration. The regulatory framework becomes more complex in dual jurisdictions, where Islamic finance exists along with conventional banking under different frameworks. In countries such as Saudi Arabia and United Arab Emirates, there is a single regulatory and supervisory framework for all financial institutions. Others, like Malaysia, Turkey or Qatar, also have a single regulatory framework, but with specific references which apply only to Islamic banks. At the other extreme, there are countries like Bahrain, Irak and Kuwait, with dual regulatory and supervisory frameworks which distinguish between conventional and Islamic institutions.

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8 The Central Bank of Malaysia issues sukuk bonds on behalf of the Government, in order to manage the liquidity of the system. It recently replaced the issuance of sukuk bonds by that of other, more short-term Islamic instruments.

9 Instruments traded in the Islamic money markets are Shari'ah-compliant. These include interbank investment (mudarabah), Government bonds or central bank issues, sale and repurchase agreements, deposits or Islamic debt certificates (public sector or private) (see the website of Malaysia's central bank: http:// iimm.bnm.gov.my/index.php?ch=4&pg=4&ac=22).

10 See IFSB (2015).

11 There are currently around one thousand Islamic investment funds, twice as many as in 2004.

12 See Di Mauro et al. (2013).

13 The variety of measures and purchase and sale transactions required by some of these instruments could give rise to indirect, multiple taxation (see IMF [2015c]).

MEMBER COUNTRIES OF THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB) (a) AND THE BANK FOR INTERNATIONAL SETTLEMENTS (BIS) **TABLE 3**

Region	Country	IFSB member (b)	BIS member
Asia	Bangladesh	F	
	Korea	A	YES
	China	A	YES
	Philippines	A	YES
	Hong Kong	A	YES
	Indonesia	F	YES
	Kazakhstan	F	
	Lebanon	A	
	Malaysia	F	YES
	Singapore	F	YES
	Thailand	A	YES
Sub-Saharan Africa	Mozambique	A	
	Nigeria	F	
	Republic of Mauritius	F	
	Senegal	A	
	South Africa		YES
	Sudan	F	
	Tanzania	A	
	Tunisia	A	
	Djibouti	F	
	Zambia	A	
International organisations	European Central Bank		YES
	Asian Development Bank	A	
	Bank for International Settlements	A	
	World Bank	A	
	International Monetary Fund	A	
	Islamic Development Bank	F	
Middle East and North Africa	Saudi Arabia	F	YES
	Bahrain	F	
	Brunei Darussalam	F	
	Egypt	F	
	United Arab Emirates	F	YES
	Iran	F	
	Jordan	F	
	Kuwait	F	
	Libya	A	
	Morocco	F	
	Oman	A	
	Pakistan	F	
	Palestine	A	
	Qatar	F	
Europe	Luxembourg	A	YES
	United Kingdom	A	YES
	Turkey	F	YES
Oceania	Australia		YES

Islamic banking penetration in the country's financial system (c)

- 100% of the system's bank assets come from Islamic banking.
- Systemic Islamic banks (> 15% of system's bank assets).
- Non-systemic Islamic banks (< 15% of system's bank assets).
- Not relevant.

SOURCE: Banco de España, based on the Islamic Financial Services Board and the Bank for International Settlements websites.

a Countries with an international organisation member.
b F: at least one full member.
A: with associated members.
c According to IFSB classification (2015).

Efforts to harmonise Islamic products and regulations[14] most notably include the work of the IFSB, whose members are official institutions from 43 countries and eight international organisations[15] (see table 3). The IFSB develops regulatory standards for Islamic finance taking the Basel regulations as the main reference framework. In this respect, the IFSB works closely with the Basel Committee on Banking Supervision, and the Bank for

14 The main institutions involved in the standardisation and harmonisation of Islamic capital markets are the International Islamic Financial Market (IIFM) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

15 It has 30 full members and 29 associate members, some being private institutions. In addition, industry representatives participate as observers.

International Settlements (BIS) is an observer member of the IFSB. Adherence to the IFSB principles and standards is voluntary and may also be partial.

The main regulatory challenge is the appropriate treatment of different risks affecting Islamic finance, both in terms of developing efficient risk management frameworks and adequate calibration of instruments for financial regulation purposes, and of the transparency implications for bank customers. Islamic institutions face a number of specific risks which include: greater liquidity risk, owing to the shortage of instruments, markets and hedging and financial derivatives instruments; greater operational risk, due to the specific contractual features of financing and the inadequate legal infrastructure, and from lower diversification since the focus is on underlying asset-based funding (sectoral concentration on real estate investment, construction or commodities); greater investment risk, owing to the uncertainty surrounding the return on investments backing these instruments; or a greater rate of return risk, owing to the risk of depositor flight if market rates rise beyond the rate of return offered by Islamic banks' own assets. However, there are certain specific aspects of Islamic finance which, in principle, provide for more financial stability than conventional finance.[16] For example, there are advantages in terms of lower leverage (loans are asset-based), greater incentive to control risks, and safety of investments, resulting from the risk-sharing framework linked to the underlying asset. Table 4 summarises the main regulatory challenges of Islamic finance.

Adapting Islamic finance to the jurisdictions of secular countries poses similar challenges. In Europe,[17] several countries are adapting their legislation to include Islamic finance, most notably the United Kingdom, Luxembourg and France. The general principle being applied is to make regulatory changes which will enable Islamic institutions to comply with the national regulatory framework on equal competitive conditions. These adaptations consist mainly of the recognition and specific calibration of Islamic finance instruments for financial regulation purposes and of regulatory changes aimed at bringing their tax treatment into line with that of conventional instruments. In this regard, some Islamic finance instruments raise the issue of double or multiple taxation, since they normally involve several transactions, each with a different form of taxation, when conventional banking would involve only one transaction. For example, mortgages based on the *murabah* and financing based on the *ijarah* principle are subject to double taxation (first, when the bank buys the house and, second, when the customer/buyer purchases the house from the bank). In the case of *sukuk* issuances, the main objective is to align the tax treatment of the profit and losses generated to that applied to the interest rates on the conventional debt instrument (mainly, tax relief from interest payments).

Islamic finance also poses significant monetary policy challenges.[18] The main challenge in this area is the development of short-term securities which may be used by Islamic institutions as collateral in their monetary transactions, and also to boost the monetary, interbank and *sukuk* markets. In parallel with improvements in macroprudential instruments

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16 IMF (2010) concludes that the initial impact of the Great Crisis on Islamic institutions was less marked than on conventional institutions, owing to the lower volume of loan portfolios, lower leverage and application of Islamic principles.

17 Application of Basel III in Europe indirectly refers to aspects of Islamic finance. More specifically, Commission Delegated Regulation (EU) 2015/61, referring to the liquidity coverage requirements for credit institutions includes, in Article 12 on "Level 2B assets" exceptions for "credit institutions which in accordance with their statutes of incorporation are unable for reasons of religious observance from holding interest bearing assets", allowing them to provide evidence of availability of non-interest bearing assets meeting these requirements and which are adequately liquid in private markets (European Union, 2014).

18 See IMF (2016).

KEY CHALLENGES OF ISLAMIC FINANCIAL SYSTEMS

TABLE 4

Aspects	Challenges and implications
Capital adequacy	The elements which may be eligible for treatment as additional Tier 1 and Tier 2 capital must be identified, with a view to applying Basel III. The asset risk assessment must also be calibrated: on one hand, transferring profit and loss from assets to liabilities reduces risk, entailing a lower capital requirement; on the other, greater exposure to liquidity risk due to the volatile prices of Islamic finance assets would suggest a higher capital requirement. In general terms, in the absence of regulatory adaptation, Islamic institutions would have to accumulate more capital than their «conventionals» competitors, affecting their profitability [Iqbal (2014)].
Liquidity ratios	Islamic institutions face a greater liquidity risk (due to the scant development of short-term liquidty markets and products, the shortage of Islamic securities/sukuk and Islamic institutions' lack of access to central bank liquidity [LoLR]), which make it advisable to strengthen their liquidity ratios. However, in order to be able to meet the net stable funding ratio (NSFR), these institutions maintain higher levels of cash and non-productive liquid assets than those of their conventional competitors, which results in less efficient liquidity management with the consequent impact on results.
Consumer and investor protection	Islamic instruments may give rise to problems as a result of the inappropriate perception on the part of consumers of their exposure to the underlying asset risk, which requires institutions to have clear and transparent customer communication policies. Also, investment account holders bear additional risks to those of conventional banking.
Financial safety nets	The main problem is that the instruments to which Islamic institutions have access are limited or non-existent. The difficulties of designing Shari'ah lender of last resort (SLOLR) facilities or deposit guarantee funds which are compatible with Islamic law hamper the efficient management of the system's liquidity
Resolution frameworks	International resolution instruments are generally applicable to Islamic institutions, but the specificities of these need to be recognised. Thus, the insolvency regime requires legislative adaptation, particularly regarding profit-sharing investment accounts and other deposit accounts.

SOURCE: Banco de España, based on International Monetary Fund (2010 and 2015a) and International Monetary Fund and World Bank (2015).

in conventional jurisdictions, Islamic regulators must strengthen their instruments, focusing particularly on the risks deriving from the close relationship between deposits and investments, and on the high concentration of assets in sectors which are closely linked to the economic cycle.

Conclusions

In recent years, Islamic finance has undergone an internationalisation process and has grown significantly. The sector has a great potential for development, taking into account the investment needs of emerging economies where Islamic finance is present, and the potential demand from the Muslim population worldwide, which has very low levels of access and use of bank services. The future development of Islamic finance requires a qualitative change in its regulation using Basel standards as the guiding reference. In this respect, the main challenges are the standardisation and harmonisation of regulatory and supervisory standards of the different Islamic jurisdictions, to facilitate their internationalisation and increase competitiveness in the sector. When part of a conventional system, Islamic finance must adapt to national legislations, without prejudice to calibrating its specific financial regulation and tax features, to allow Islamic institutions to participate in equal competitive conditions.

14.10.2016

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