

Is Time Ripe to Adopt Islamic Financial Systems in Secular Developing Countries? A Review of Literature

Byson Beracah Majanga¹

¹ University of Malawi-The Polytechnic

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Abstract

The global financial crisis of 2007/8 is considered to be the worst after the 1930 Great Depression. Most finance scholars argue that the crisis was a sole result of the weaknesses of the interest related traditional or conventional banking system commonly used in almost all countries in the world. Islamic finance scholars contend that the crises would have been avoided, and that will never be experienced, if the world adopted Islamic banking principles rather than clinging on to the conventional banking systems. Since Islamic financial systems are linked to, and associated with the principles of Islamic religion, other scholars maintain that the conventional systems remain the best as they accommodate all persons without being aligned to the principles of a particular religion. That aside, studies show that Islamic banking has registered a reasonable growth in asset base, especially in the Islamic nations and efforts are still there to break into the economies which are non Islamic. This study analyses the basic principles of Islamic banking in comparison with the conventional systems, and looks at the challenges and opportunities that may arise in an economy when the two systems run and operate concurrently. The paper concludes that much as the two systems can complement each other in a nation, the respective regulators must weigh the benefits and costs arising from an involvement of a new banking system in an economy. The paper further provides room for further research on the subject matter on the basis of individual country's regulations regarding its financial systems.

Index terms— islamic finance, conventional banking, economic growth.

1 Introduction

financial system plays a vital role in the economic growth of a country by providing a link between those who save a part of their income to those who invest in productive assets, thereby providing a smooth and even flow of funds in the economy, and mobilising and usefully allocating scarce resources of a country. A financial system is a complex well integrated set of sub systems of financial institutions, markets, instruments and services which facilitate the transfer and allocation of funds, efficiently and effectively (Kohn, 2004). Through the generation of savings, investment, capital formation and growth, the financial system is possibly the most important institutional and functional vehicle for economic transformation. With a focus on its purposes, Van Horne & Wachowicz (2008) define the financial system as the purpose of financial markets to allocate savings efficiently in an economy to ultimate users either for investment in real assets or for consumption. The definition by Van Horne & Wachowicz (2008) extends and supports that of Christy & Roden (1976) who opined that the objective of the financial system is to supply funds to various sectors and activities of the economy in ways that promote the fullest possible utilisation of resources without the destabilizing consequence of price level changes or unnecessary interference with individual desires. According to Robinson (1995), the primary function of the

system is to provide a link between savings and investment for the creation of new wealth and to permit portfolio adjustment in the composition of the existing wealth. The definitions given by and Robinson (1995); Christy & Roden (1976) and Van Horne & Wachowicz (2008), clearly demonstrate the importance of a strong financial system to the growth of a country's economy in as far as the flow of funds is concerned.

The global financial market operates under two main financial systems which are the conventional banking system and the Islamic banking system. The conventional banking system was founded on the principles of economics where a bank receives deposits from savers and avails the money to borrowers at an interest, part of which is used to compensate the depositors or lenders. On the contrary, Islamic banking was not founded on the principles of economics but rather on the principles of Islamic (or Sharia) laws. While conventional finance helps direct the flow of capital to investment opportunities that are supposed to provide the highest return in the market, Islamic finance allegedly seeks socioeconomic optimality in line with Islamic norms (Aytug & Ozturk, 2015). Instead of charging interest to the borrower, Islamic finance believes in sharing the risks associated with any activity the borrower intends to engage in with the borrowed funds (Pepinsky, 2010). Globally, growth of Islamic banks is on the increase of late with assets accumulating to over \$1.7 trillion and annual growth estimated at 17.6% (World Islamic Banking Competitiveness Report 2013/14) especially in the developing economies in the Middle-East, and South East Asia and some Arab states in Africa (Gait & Worthington, 2007). Specifically, Islamic banking, which is run according to the Sharia principles, has some features which do not apply in conventional banking and these features are one of the sources of resistance among the secular nations to adopt Islamic finance systems. Some of the features which have been considered as a major part of this study include:

- a) Prohibitions from investing in businesses involved in alcohol, gambling, drugs, tobacco, weapons, pork or anything deemed illegal by Islamic laws.
- b) Existence of the Sharia Board to oversee and regulate the operations of an Islamic bank in a country.
- c) Prohibition from investing in companies having too much borrowing of at least 33% of a company's stock market value.
- d) Prohibition from transactions which involve speculation or expectation of extreme risk.

The purpose of this study is to assess the possibility of a co-existence between the two banking systems in an economy which is not under any significant influence of a particular religious sect. To accomplish this objective, the study emphasises on review of existing literature on Islamic and non Islamic nations and how their respective financial regulations, conditions and legal environments would ensure the coexistence of the two systems, and finally provides recommendations based on the literature.

2 II.

3 Literature Review

Studies reveal that Islamic banking was there in the ancient days during the 7th century before colonisation of Arab nations by the West (Moore, 1997), and that since then up to the 19th century all the Muslim countries were under the Western colonial masters who brought the capitalist system thereby making Islamic finance system less effective (Anwar, 1995). As most Arab countries were getting their independence in the 19th century, Islamic economists considered reintroducing the Islamic principles in running their financial systems. It is suggested, according to Iqbal & Molyneux (2005), that the first attempt to establish an Islamic bank was in 1971 in Egypt. Since then Islamic banking industry grew at impressive rates and according to banking statistics the growth rate of Islamic banking has outpaced that of the traditional banking in the past two decades (Ghannadian & Goswami, 2004). Most researchers have pondered on fundamental questions relating to whether Islamic banks are unique from an economic standpoint. Islamic banks have been compared to their conventional counterparts on various measures such as efficiency, liquidity and profitability. In addition, capital market products such as Islamic mutual funds have also been the subject of recent research (Omar, 2015). Mirakhor & Bao (2013) argue that before the inception of the Islamic finance industry, there was what could be called a market failure in the conventional financial system due to the substantial unmet demand for financial products in compliance with Islamic belief. The Islamic finance industry therefore grew out of the conventional finance subsystem to meet this demand. In his paper regarding the global financial crisis, Hassan (2010) shows how Islamic economic systems can bring the much needed financial stability which he argues the financial economic system has failed to achieve. In their paper, Imam & Kpodar (2015) found that regardless of its relatively small size, Islamic banking is positively associated with economic growth even after controlling for various determinants, including the level of financial depth. Islamic finance could, according to Sheng & Singh (2013) become a formidable competitor to the current dominant financial system and as a result, the world would have much to gain if the two systems were to compete fairly and constructively to meet people's needs for different types of finance. Sheng and Singh (2013) also touted the cooperation between these two systems as eminently desirable as they could cooperate and even compete to produce the best outcome for common projects, such as the provision of cheap banking for the world's poor or for investment in environmental undertakings. Researchers argue that it is likely that Islamic banking and conventional banking will not have different impacts on economic growth as long as they finance the same projects (Imam & Kpodar, 2015). However, Islamic banking is said to have more advantages compared to conventional banking even beyond the borders of Islamic nations. Unlike in conventional banking where lending is based on risk shifting, in Islamic banking lending is based on risk sharing which in principle encourages more investment by individuals (Ben-Naceur, Arajas & Massara, 2015). According to El-Gawady

(2008), the Islamic banks attach varying degrees of importance to the elements of the 5Cs (that is, capacity, capital, collateral, character and conditions) from that of the conventional or commercial banks. The commercial bank gives priority to the collateral, whereas the Islamic bank gives priority to character of customer. Whereas the commercial banks are more interested in the capital and capacity, the Islamic banks are more interested in capacity than in capital. However, El-Gawady (2008) concedes that there may be some similarity between the commercial bank and the Islamic bank on the issue of priority attached to the security and soundness of any project submitted to the bank for the purpose of financing. The fact that Islamic finance subscribes to the beliefs of a particular sect of people, its operations could see more individuals and firms making savings in a formal financial sector in a country (Demirguc-Kunt, Klapper, & Randall, 2013) and that by not being involved in derivatives and other complex instruments which lead to speculations, Islamic banks are considered likely to contribute to financial stability, especially during financial crises as research has proved that Islamic banks performed twice as much better than conventional ones during the 2007/8 global financial crisis (Hassan & Dridi, 2010). Islamic banks however, by virtue of being newer and smaller in contrast with conventional banks, lack economies of scale (Hassan & Dridi, 2010) and therefore lack efficiency and cost effectiveness in their operations (Beck, Demirguc-Kunt & Merrouche, 2010); and Islamic banking systems lack liquid instruments (Moody's, 2009) which in turn limit investors' participation on the money market. In comparing the superiority of the two banking systems, Safiullah (2010), in his study finds that the interest based conventional banking performs better based on commitment to economy and community, productivity and efficiency whereas the interest free Islamic banking performs better based on business development, profitability, liquidity and solvency. In his study, Massoud (2015) concluded that while Islamic finance is in theory believed to be a plausible alternative to conventional banking, in practice, it fails to do so due to the high levels of operational and liquidity risks, and failure to provide a new range of products to its customers.

4 a) Islamic and secular economies

A secular state is a concept of secularism, whereby a state or country purports to be officially neutral in matters of religion, supporting neither religion nor irreligion. Such states also claim to treat all citizens equally regardless of religion, and claim to avoid preferential treatment for a citizen from a particular religion/non religion over other religions/non religion. Secular states do not have a state religion (established religion) or equivalent, although the absence of a state religion does not necessarily mean that a state is fully secular; however, a true secular state should steadfastly maintain national governance without influence from religious factions. On the other hand, an Islamic state is a type of government, in which the primary basis for government is the enforcement of Sharia, dispensation of justice, maintenance of law and order. Investors may prefer an economic system which is based on a religious principle than a secular one because according to Badshah, Mellemvik & Timoshenko (2013), religion shapes and enforces ethical behaviour and therefore societies which have religious values of justice, truthfulness and honesty may be characterized by a high level of trust in financial and business affairs. The affiliation and linkage of Islamic banking systems to the Islamic principles of Sharia poses a great challenge to their establishment and development in non Islamic and secular states. Many banking beneficiaries consider Islamic banking as a way of advancing one religion at the expense of others and this view brings heavy resistance among the populace in a secular state. According to Joy Online, many Christian leaders argue that promoting Islamic finance at a time when security forces across the globe are battling Islamic fundamentalists could be dangerous to the world economy at large. According to them, the world is not yet mature for Islamic banking which is being promoted by the World Bank Group. This perception is also supported by Bello & Abubakar (2014) who, in their study confirm that Islamic banking systems face operational challenges in the form of religious and cultural differences in Nigeria. Regardless of this fact, Bello & Abubakar (2014) still maintain that Islamic banking is still possible in Nigeria, which has an almost equal proportion of Muslims to Christians (Index Mundi, 2014), due to the fact that there is a large market for it; it has constitutional backing; it provides a choice of investment to its clients; the presence of a new Central Bank of Nigeria's regulatory framework for Islamic finance; its advantages over conventional banking, which are zero interest rate, equitable distribution of wealth, lawful transactions, promotion of morality in transactions and others. Regardless of the differences in religious principles, the two financial systems are on record to have contributed immensely towards the global economic development. A strong and resilient banking system is the foundation for sustainable economic growth, as it offers improved financial decisions, supports the better distribution of resources and thereby accelerates economic growth (Monnin & Jokipii, 2010) and Haldane, Brennan, & Madouros (2010). Moreover, banks provide critical services to consumers, small and medium-sized enterprises, large corporate firms and governments who rely on them to conduct their daily business, both at domestic and international levels. Any modern financial system contributes to economic development and the improvement in living standards by providing various services to the rest of the economy which include clearing and settlement systems to facilitate trade, channeling financial resources between savers and borrowers, and various products to deal with risk and uncertainty (Bollard, Hunt & Hodgetts, 2011). Most researchers have studied the global economic performance of various individual firms and countries operating under the conventional banking systems which are synonymous with charging interests on loans unlike sharing the risks with borrowers as is the case with Islamic banking systems. Benhayoun, Chairi, Gonnouni & Lyhyaoui (2014) concluded through SVM prediction model that interests on loans can highly increase unexpected financial crises in individual companies as well as countries. These results are supported by the findings of Fauzi, Locke,

Basyith, and Idris (2015) which revealed that Islamic debt has a significant positive impact on company value and financial performance, and that the coefficient for Islamic debt is higher than that for non-Islamic debt, suggesting that the Islamic debt provides a higher contribution to firm value and to the improvement of firms' financial performance compared to non-Islamic debt. In another study, Tabash & Dhankar (2014) analysed empirically the relationship between the development of Islamic finance system and growth of the economy in the United Arab Emirates (UAE), using time series data from 1990 to 2010 with Islamic banks' financing credited to private sector through modes of financing as a proxy for the development of Islamic finance system and Gross Domestic Product (GDP), Gross Fixed Capital Formation (GFCF) and Foreign Direct Investment inflow (FDI) as proxies for real economic growth. Their findings indicate the existence of a causal relationship between Islamic banks' financing to economic growth, and that Islamic banks' financing has contributed to the increase of investment and in attracting Foreign Direct Investment inflow (FDI) in the long term and in a positive way in UAE. Islamic banking, though considered new and young, is globally growing as measured by assets and the growth is expected to increase in the future (El-Hersh, 2014). The growth of Islamic assets is shown in the figure below:

5 Discussion of Shariah Prohibitions in Relation to

Conventional Banking Secular countries can welcome and accommodate Islamic banking systems initially by creating Islamic windows within their own conventional banks (Di Mauro, et al, 2013) Once a conventional bank has operated an Islamic window for some time and has gathered a sizeable customer base for its Islamic activities, it may decide to establish an Islamic subsidiary, or even fully convert into a full-fledged Islamic bank where it will be able to offer, under one roof, a wider range of Shariah-compliant banking products than through the Islamic window alone (Sole, 2007). Similarly, Gelbard, et al (2014) suggest that as a first step, policy makers could introduce Islamic financing windows within of the conventional system and facilitate sukuk issuance to tap foreign investors and that establishment of full-fledged Islamic banks require addressing systemic issues, and adapting the crisis management and resolution frameworks which the IMF can assist by sharing international experiences and providing advice on supervisory and regulatory frameworks as needed. Below is the discussion of some of the possible areas, arising from Islamic prohibitions, which may breed conflicts between the two systems, conventional and Islamic banking systems. The paper looks at these areas from both a positive and a negative side on the economic impact.

Islamic banking systems prohibits investments in businesses dealing with alcohol, gambling, drugs, tobacco, weapons, pork or anything else considered illegal by the sharia (HSBC Global Asset Management, 2011). Industries involved in these activities contribute greatly to the national economy and therefore these industries would not benefit from the services of the Islamic banks. The only way out for these would be the conventional banks and therefore the country's financial system would be segregatory. This could have a negative impact on industry performance hence economic growth. According to the Institute of Alcohol Studies (2013), the production and consumption of alcohol products contribute greatly to the global economy from three fronts namely, monetary value in sales, taxation received by the treasury, as well as job creation. The Institute argues that the industry directly employs 650,000 people in the UK alone, and contributes about 13.5% of tax receipts to the revenue authorities. The report further argues that alcohol products have contributed heavily towards the annual The Institute, however, acknowledges the externalities associated with alcohol production and consumption and in their report, they categorise costs in the view of health, crime and loss of productivity. In UK, the three costs were summarised as shown in figure ?? above. On a similar note, the report released by the Canadian Gaming Association (2008), concludes that responsible gaming has contributed to the Canadian economy directly and indirectly in form of revenue contribution, tourists attraction and job creations. The conclusion by the CGA is supported by Bazelon, Neels and Seth (2012), who in their report assessing the economic impacts of the commercial casino industry show that the industry supported approximately \$125 billion in spending and nearly 820,000 jobs in the U.S. economy in 2010, which is roughly equivalent to 1 percent of the \$14.5 trillion U.S. GDP. Though there is a minor drop in export of tobacco in Malawi, one of the developing countries in Africa, records still maintain that tobacco takes a large proportion of the country's exports per annum (Ngwira, 2012). Furthermore, reports show that the global tobacco industry contributes substantially to the economies of more than 100 countries, and millions of people worldwide depend on it for employment. Even in countries that do not have tobacco manufacturing or leaf growing activities, tobacco retail and distribution is an important source of economic activity (British American Tobacco, 2013). The operation of Islamic banking system requires total compliance to Sharia and the presence of the Sharia board to oversee the system (Sole, 2007). To successfully operate, an Islamic bank needs to be regulated by a regulator made up of a combination of Sharia experts and ordinary secular experts. Ordinarily, secular countries that are developing have their central banks which take the overseeing and supervisory role of financial institutions. The coming in of the Sharia board, which is the main overseer of Islamic banking and financial institutions (Hassan, 2007) would cause a conflict as both the board the central banks will have the same mandate but viewed from different principles. Further, Alaro & Zubair (2009) argue that as long as the conventional financial institutions have not amended their basic laws and charters to conform to the Sharia standards, there can be no basis for an arm of them claiming to be independently Sharia compatible. Alaro & Zubair (2009) see the situation as the way to succumb to a ploy of allowing conventional banks to engage in deceitful acts of exploiting the uninformed investors on

the one hand, and unfairly competing with bona fide Islamic financial institutions on the other hand. Unlike conventional banking, Islamic banking laws prohibit investing in companies that have too much borrowing of at least 33% of the company's stock market value. In agreement to this prohibition, Akeem, et al (2014) observed in their study findings that capital structure measures are negatively related to firm performance, and went further to recommend that firms should use more of equity than debt in financing their business activities. They however, acknowledge that a firm's value can be enhanced using debt capital than equity capital. Similar findings were also reported by Nirajini & Priya (2013) who establish a correlation between capital structure and financial performance of trading companies listed in Sri Lanka. Although it is recognised that moderate levels of debt improve welfare and enhance growth at national, corporate and household level, Cecchetti, Mohanty & Zampolli (2011 and Ogebe, Ogebe & Alewi (2013) suggest the need for establishment of thresholds or limits to the composition of debts in a nation, corporate and household level, as too much debt becomes a drag to growth. Most companies in the developing countries, as well as developed countries survive on borrowing even to the extent of having a debt/equity ratio of more than 80%. Such companies have been registering a sound performance and have gradually reduced the gearing situation to acceptable levels. Apart from its importance in the banking sector, risk management as well leads to the success of firms in different sectors. The study by Didraga (2013) on project management showed that risk management is a very important component of the project management process and it is assumed implicitly to work in favour of project success. The hibah, which is a voluntary gift Islamic banks make to their customers on their savings account balances, is a variant of interest an investor receives from their deposits with a commercial bank. According to Gait & Worthington (2007), unlike conventional banks, banks and customers in Islamic banking systems do not earn money returns without evidence of a direct collaboration between capital and effort. Therefore, Islamic banks cannot act as a financial intermediary in the strictest sense since this would involve accepting deposits from individuals or firms, who anticipate interests; and lending them to borrowers (at an interest as well) who are also individuals or firms. Since the hibah is a voluntary gift, there is a possibility that banks may not give it out due to some other circumstances even after using the customers' funds for their operations. This according to Moody's (2009) would discourage private investors from participating in the money markets.

IV.

6 Conclusion

The advent of Islamic finance, if looked at from a neutral point of view, and not from a religious perspective, could be a blessing in disguise considering the social economic benefits and contributions the system has made to the economy world over as revealed by literature. The challenge, however, is that the system is inseparable from the principles of a particular religion, making the general public associate it with Muslim investors only. Literature has shown that the two financial systems can operate together in a secular nation where they may complement each other as each system has its own operational weaknesses and challenges. The authorities in the countries should however consider the social and economic consequences and or benefits arising from the adoption of the new financial system to be introduced. A proper cost benefit analysis is required considering the fact each system has its own effects on the social economic well being of the citizenry especially in the developing nations. All in all, studies have shown that Islamic finance can make a good complement and not a substitute to the traditional systems that reign in the developing and secular nations. ¹

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Figure 1: Figure 1 :

time in a competitive market. They found that gearing has direct relationship with the performance of a company and provides some financial advantages with 7 positive impact on profitability. A similar study conducted by Audretsch & Lehmann (2003) on firms 6 listed on the Neuer Markt in German revealed that small 5 and innovative firms prefer to be financed by venture capitalists (a very expensive source of debt capital) and 4 that the performances of such firms exceed that of those value 3 financed by other means. By prohibiting transactions which involve speculation or expectation of extreme risk, 2 the Islamic financial system limits, or at times entirely 1 prohibits the operation of the futures and the option 0 markets which are crucial in managing risks in 2 investment and financial decision making. Of late, the 2 2 2 2 2 2 2 2 2 volume of international trade and business has increased due to globalisation and liberalisation making the business environment more risky than it was 10 (Jecheche, 2012). The risky environment has not spared 8 the banks and inefficient risk management techniques have led to the collapse of a number of financial 6 Value institutions. Channar, Abbasi & Maheshwar (2015) in 4 their study found that Conventional Banks have more 2 effective risk management process as compared to the 0 Islamic Banks. They also found that risk management has a positive relationship with financial performance.

Figure 2:

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