INTER-BANK COOPERATION BETWEEN ISLAMIC AND CONVENTIONAL BANKS IN PAKISTAN

By

Shakir ULLAH

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
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2007

KDI 국제정책대학원
KDI School of Public Policy and Management

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ABSTRACT

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BY

Shakir Ullah[1]

Fast growth of Islamic finance in recent years has created a huge opportunity for cooperation between the Islamic and the conventional financial institutions. Such cooperation to date has been most frequently observed in financing large development projects, like real estate and natural resource explorations. Even though active research efforts have been put into Islamization of conventional financial products, little research on the potential for cooperation between the Islamic and the conventional financial systems has been published. In this paper, we develop several deal structures that could help to expand cooperation between the two financial systems. We show several variations of the project financing structure that may provide conduits for the Islamic money to flow into developing countries like Pakistan, where potentially lucrative investment opportunities are currently not fully utilized either due to a gap in risk characteristics between entrepreneurs and bankers or simply due to shortage of capital.

[1] MBA Student (2006), KDI School of Public Policy and Management, Korea
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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

1. Introduction

The surge in Islamic finance industry is coincides with the current account surpluses of oil-exporting Islamic countries, but its continued growth reflects the influence of other factors such as the desire for sociopolitical and economic systems based on Islamic principles and a stronger Islamic identity. In addition, introduction of broad macroeconomic and structural reforms in financial systems, liberalization of capital movements, privatization, and global integration of financial markets have paved the way for the expansion of Islamic finance.[2] Given that the Islamic financial industry has grown to an extent that cannot be ignored anymore and that the Islamic and the conventional financial institutions coexist in many countries, there appears an ample need for cooperation between the two systems. We have recently seen some fascinating developments in this regard. For example, Citibank, HSBC, Goldman Sachs, BNP-Paribas and UBS have already established *Shariah* compatible services.[3] The entrance of these international banks, combined with the participation of local institutions, has led to a surge in innovation in Islamic finance in the Middle East.[4]

The differences in the basic principles of Islamic and conventional financial systems have

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[2] The Middle Eastern Muslims countries have exhibited strong financial growth since their liberalization from western colonialism. This growth led to demand for sound banking and financial services that are also complaint with Sharia. Moreover, the privatization in some Muslim countries like Pakistan has added to the development of the Islamic Financial Industry. Also countries like Pakistan, Iran, Malaysia etc have adopted Islamic Financial regulations in order to support the industry on macro economic level.

[3] See Sundararajan & Errico (2002).

[4] Sawyer, Nick (Sept, 2006)

critically hindered further expansion of cooperation between them.[5] For example, income-sharing, not interest-taking, is a salient feature of the Islamic financial system, but profit-sharing banking is a relatively new concept to most CFIs.[6] As a result, income-sharing banks are found mostly in Islamic countries or in countries where OPEC oil revenues have been invested.[7] In a typical IFI, sale and lease-based transactions dominate the asset portfolios and can exceed 80%, with the remainder allocated to profit-sharing arrangements.[8] In such banks, the relationships between depositors and the bank and between the bank and bank-investee can best be described as agency relationships.[9]

Due to such fundamental differences, cooperation between the two financial systems have been limited mostly to financing large projects conducted in the Middle East for which CFIs – most of which are based in western countries - invite Islamic money for the purpose of risk sharing or simply to facilitate negotiations with host countries. There may exist, however, abundant opportunities for productive investments in the fast-growing countries in Asia, but many of their FIs are either too risk-averse or suffering from short supply of money to fully utilize such opportunities.[10] One such example is Pakistan which has been growing at an average rate of 7% for the past few years and the domestic

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[5] Conventional financial systems are based on interest which is completely banned in Islamic finance. Further, conventional financial system focuses primarily on the economic and financial aspects of transactions, while the Islamic system places equal emphasis on the ethical, moral, social, and religious dimensions to enhance equality and fairness for the good of society as a whole. The system can be fully appreciated only in the context of Islam's teachings on the work-ethics, wealth distribution, social and economic justice and the role of the state. For detailed discussion on the topic, see the article "*Islamic Financial System*" by Zamir Iqbal on World Bank's website.

[6] See Khalid Mohammed Boodai (1980).

[7] See Fredrick Vernon Iffert (1989).

[8] See Iqbal and Mirakhor (2002).

[9] See Archer, S. and Abdel Karim, R. (1997).

[10] One such example is Pakistan. The average economic growth rate of Pakistan has been about 6.5% for the past few years. There are abundant of investment opportunities in the development sector where a large number of projects are underway. The funding for these projects is usually borrowed from IMF and World Bank which is quite expensive.

financial institutions are unable to finance the fast industrial expansion. In these countries, the fact that Islam presents its own macro-economic system which is different from the capitalist and socialist systems may create incentives for corporations to seek funding from IFIs rather than CFIs.[11] For example, young companies which focus on new technologies can easily face prohibitive costs in obtaining external capital from CFIs because they operate in a highly uncertain environment. For such companies, getting capital from IFIs on profit-sharing basis could become the best option.[12] Likewise, corporate restructuring with a non-interest-based funding from IFIs may turn out to be a good opportunity for financially-troubled young companies.[13]

Although extensive research work is being carried out on developing Sharia-compliant products for IFIs, there has not been much research on the possibility of cooperation between Islamic and conventional financial systems that can facilitate the flow of funds form Islamic to conventional banks and vice versa. This paper attempts to develop several deal mechanisms that may facilitate such capital flows. Although the paper presents a few theoritical models that can bridge the conventional and Islamic finacial systems for funding the tremendous economic growth and industrial expansion in Pakistan, it can also be applied to other countries by incorporating necessary adjustments according to the particular needs of the target countries.

The paper has been divided into 5 sections. Section 1 is introduction; Section 2 of the paper provides a general overview of the trends in the global Islamic financial industry with particular emphases on Islamic finance industry in Pakistan. Section 3 compares the

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[11] See Chapra (1992 and 2000).
[12] See Sami Al-Suwailem (1995).
[13] See Muhammad Mazhar Iqbal (1995)

conventional and Islamic financial systems and identifies obstacles that hinder cooperation between the two systems. Section 4 looks into possible ways of making a bridge between them and develops several deal structures with a subsection on the implications of these models for Pakistan. Section 5 provides a brief conclusion of the paper.

2. Global Trends in Islamic Financial Industry

Islamic financial system is as old as the religion itself that appeared about 1400 years ago[14], but the modern, institutionalized form of such principles first appeared only about 4 decades ago, when the first Islamic bank was established in Egypt in 1963[15]. Islamic Finance has been exhibiting rapid growth worldwide since then. Presently, it is estimated that Islamic financial institutions (IFIs) possess some US$300 [16]billions (Fig. 1) of assets all over the world, with worldwide existence of about 300 [17] institutions. Some researchers even predicted that Islamic finance would attract 40% of the total savings of

[14] Islam is the guiding source of Islamic Finance and the history of Islam is about 1400 years old when this religion came into existence in early 7th century. Interest on loan was prohibited in those days by the Prophet Mohammad (PBUH). The system of Zakat was introduced and an ethical base was setup for businesses in Islamic perspective.

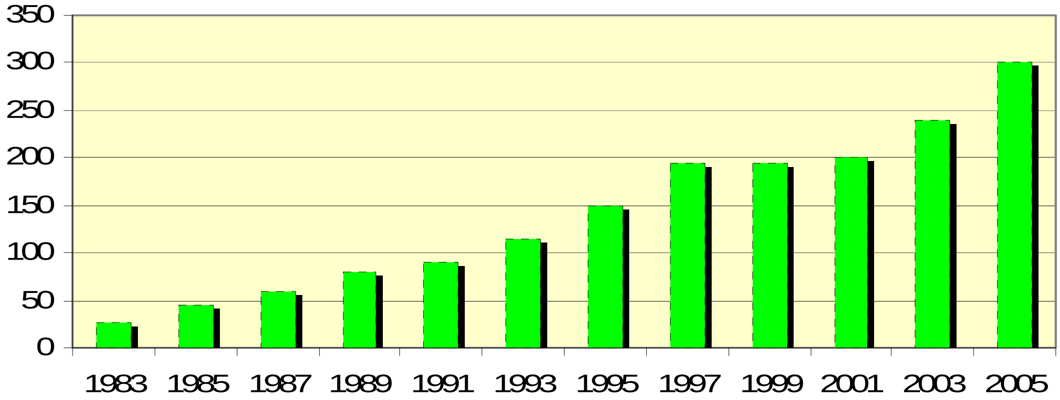
[15] There are different views about the first IFI in recent history but references are often made to Mitghamr Egypt Savings Association that was founded in 1963. See Ali (2002) and Archer and Ahmed (2003).

[16] According to the S&P statistics (The Gulf Daily News May 2, 2006) the Islamic finance industry is expected to be worth US$ 500 billion. For the growth trends in Islamic Finance Industry since the past three decades, please see the 2005 report of the Association de'Financiere.

[17] There are different reports about the number of IFIs and the size of the Islamic Financial Market. A 2006 report of Moody's states that there are 300 IFIs with more than US$ 250 billion assets and growth rate of 10–15% a year (see Moody's Report, April 2006). Also the General Council for Islamic Banks and Financial Institutions reports that there is a total of 284 businesses offering Islamic financial services and managing US$ 178.5 billion (General Council for Islamic Banks and Financial Institutions (GCIBAFI), 2005). A recent paper shows that there are 200 IFI today (Dahlia El-Hawary, Wafik Grais and Zamir Iqbal, 2006)

the Muslim population worldwide within the next few years.[18]

Fig. 1: Trends in the Size of Islamic Finance Industry from 1983 to 2005 (In Billions of US Dollars)



Source: Report of Association d'Economic Financiere (2005)

Islamic finance has emerged from a myth to an unavoidable phenomenon in the global financial system, and has become a strong counterpart of the conventional financial system. The portion of financial assets managed by IFIs is, however, still very small as compared to the total assets of the conventional financial institutions (CFIs). Today IFIs actively operate not only in Muslim countries but also in many of the non-Muslim countries (Table. 1), but Islamic finance has not yet dominated conventional finance even in the Islamic countries. Some researchers claim that it has not been very easy for islamic banks to correctly apply the islamic law to banking transactions because of the dominance of the conventional financial system.[19]

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[18] See Zaher & Hassan (2001).
[19] See Bahgat Bahgat Khalil El Sharif (1990).

Table 1: Examples of Countries Providing Islamic Financial Services

Muslim Countries		Non-Muslim Countries	
Albania	Malaysia	Australia	The Philippines
Algeria	Mauritania	Bahamas	Russia
Bangladesh	Morocco	British Virgin Islands	Singapore
Brunei	Niger	Canada	South Africa
Djibouti	Pakistan	Cayman Islands	Sri Lanka
Egypt	Palestine	China	Switzerland
Gambia	Qatar	France	Thailand
Guinea	Saudi Arabia	Germany	Trinidad and Tobago
Indonesia	Senegal	India	UK
Ivorey Coast	Sudan	Ireland	USA
Jordan	Turkey	Luxembourg	New Zealand
Kuwait	UAE	The Netherlands	

Source: Council for Islamic Banks and Financial Institutions

There have been regulatory changes towards the Islamizaton of the financial system in the past few years in the Muslim world[20]. Especially, Malaysia and Bahrain have been intensively competing with each other to become the hub for Islamic finance, and thus have played a key role in the development of present day global Islamic finance industry.[21] The kingdom of Bahrain is also expected to take steps on macro economic level to transform the economy into a purely Islamic economy[22]. As a result of such

[20] Pakistan, Iran, Lebanon, Malaysia and some other islamic countries have developed Islamic financeial regulations in order to regulate the growing trend of the industry in these countries. The governments of these countries are also committed to gradually transform the financial system into an Islamic one
[21] Bahrain is leading in terms of volume of Islamic financial transactions while Malaysia is leading in terms of a sound regulatory system for Islamic finance. According to the Global Sukkuk Table, Bharain has the greatest concentration of Islamic real estate projects

[22] Professor Awan, Head of the Faculty of Sharia at INCEIF, expects that Bahrain can play a leadership role in adopting new monetary policy tools for macro economy management as the share of Islamic finance grows in size. The precedents set in Bahrain will be followed by other Muslim countries just as the co-

developments, IFIs have developed a vast range of products designed to serve the growing market. These products cater for housing and consumer finance, business loans and project funding (table 2).

Table 2: List of the standard Islamic banking products

Product	Meaning	Description
Murabaha	Intermediation	Buying goods needed by clients and then selling them later at a profit
Mudharaba	Sponsorship	Financial institution provides funds and the company manages the funds with no financial liability on the company in case of losses
Musharaka	Partnership	A joint venture where the business owner and financial institution, both, provide funds and bear losses
Ijara	Capital Leasing	Similar to conventional leasing but calculations are made on rental bases
Wakala	Agency	An agency contract which generally includes expert's fees for the financial institution
Salam	Forward Selling	A short-term agreement under which a financial institution pays, in advance, amounts corresponding to the future delivery of a defined quantity of goods
Istisna	Contracting Agreement	A variation of Salam under which a financial institution pays, in advance, amounts corresponding to the future delivery of a defined quantity of goods

Currently, banking is the most developed part of the Islamic financial system. In Egypt, Iran, Indonesia, Malaysia, Pakistan, Sudan, and the Gulf Cooperation Council (GCC) countries, Islamic banking exists alongside conventional banking. There are two main channels for Islamic banking these days; 1) Full Islamic Banks and 2) Islamic banking windows of conventional banks (Table 3).

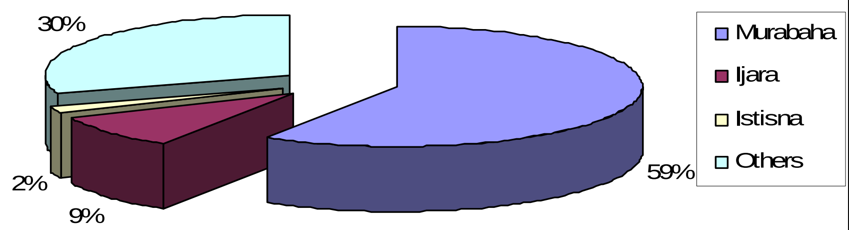
existence model of Islamic and conventional finance perfected in Bahrain has been followed by other countries (World Islamic Banking Conference 2006).

Table 3: Examples of Full Islamic Banks and Islamic Window operations of conventional banks.

Examples of Full Islamic Financial Institutions	Examples of International Financial Institutions having Islamic Window Operations
1. 1st Ethical (United Kingdom)	1. Citybank
2. Al Aman Takaful Insurance (SAL) (التكافلي للتأمين الأمان) (Lebanon)	2. HSBC
3. A'Yan Leasing & Investment Co (الإستثمار و للتجارة أعيان شركة) (Kuwait)	3. Standard Chartered Bank
4. Al Baraka Banking Group – ABG (المصرفية البركة مجموعة) (Bahrain)	4. ABN Amro
5. American Finance House (LaRiba) (United States)	5. Goldman Sachs
6. Bank AlJazira (الجزيرة بنك) (Saudi Arabia)	6. BNP Paribas
7. Bank Eghtesad-e-Novin (Bank Eghtesad-e-Novin) (Iran)	7. UBS
8. Bank Albilad (البلاد بنك) (Saudi Arabia)	8. Chase

The most dominant Islamic finance product is Murabaha that captures about 59% of all the value of Islamic banking products (Fig. 2). Ijara, the second largest in volume among banking products, has only 9% market share. Dominance of banking products has caused shortage of liquidity-enhancing instruments, thus eliminating a large segment of potential investors in the Islamic financial markets. More liquid instruments are fast emerging in recent years through securitization, however, and Malaysia and Bahrain have been instrumental in launching tradable securities that have created much needed liquidity and a secondary market for institutional investors in the Islamic financial market. Islamic funds, with a current market size of USD16 billion, represent the initial application of securitization[23]. Several "Islamic equity" investment funds have also been launched, with both FTSE[24] and Dow Jones [25]providing indices to monitor this growing market.

Fig. 2: Breakdown of Islamic Banking Products



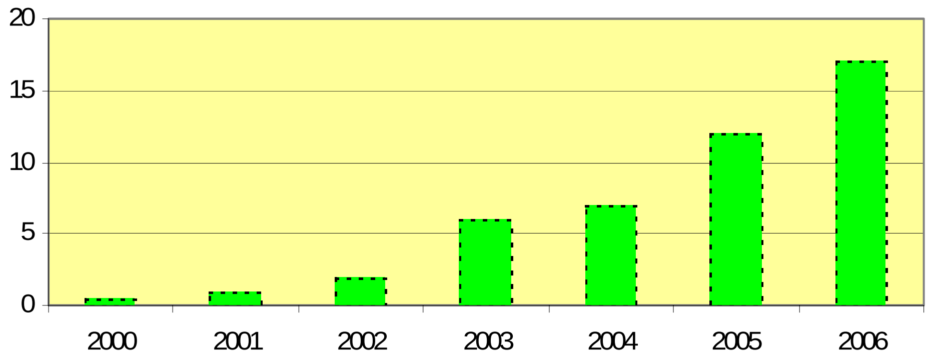
Source: Report of Association d'Economic Financiere (2005)

Equity funds, the largest share of the Islamic funds market, are the same as conventional mutual funds but with an Islamic touch that requires a unique "filtration" process [26]to select appropriate shares. The future of Islamic equity funds is bright in part because of a new wave of privatization under way in Muslim countries such as Egypt and Jordan, and in high-growth Islamic countries such as Indonesia, Malaysia and Pakistan, where the demand for Islamic financial products is growing rapidly. Sukkuk (Islamic Bond) is the fastest growing product of Islamic finance. Sukkuk has become a global product with both issuers and investors from all around the word. Sukkuk is similar to asset-backed bonds, but instead of a fixed annual interest rate, payouts to investors over the life of the

[23] For recent values of and updates on securitization and issued Sukkuk, visit Liquidity Management Center, Bahrain at http://www.lmcbahrain.com/global-table.asp
[24] http://www.factset.com/www_607.aspx
[25] The Dow Jones Islamic Market Indexes were introduced in 1999 as the first benchmarks to represent Islamic-compliant portfolios. Today the series encompasses more than 60 indexes and remains a comprehensive family of Islamic market measures.
[26] The Islamic equity funds invest in Sharia-complaint companies. According to the filtration process of Dow Jones Islamic Index, companies with a debt financing of not more than 33% are selected, provided that the debt does not remain a permanent feature of the capital structure. Also, the companies should not have businesses related alcoholic beverages, pork etc.

bond are derived from leases, profits or sales of tangible assets such as property, equipment or a joint-venture business.[27] According to London's Islamic Finance Information Service, $16.9 billion in Sukkuk was issued between January and October 2006 - 43% more than the total in 2005 (Fig. 3).

Fig. 3: Total Issued Sukkuk from 2000 to 2006 (In Billions of US Dollars)



Source: Islamic Finance Information Service

2.1. Islamic Financial Industry in Pakistan

Pakistan is the second largest Muslim country in the world in terms of population.[28] It was formed by the division of British India into India and Pakistan in 1947. Islamization of the financial industry was initiated in the late 70s (chronology given in table 4).[29]

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[27] **Karen Lane, Islamic-Bond Market Becomes Global By Attracting Non-Muslim Borrowers, Wall Street Journal,** ***November 16, 2006; Page C1***

[28] With a total population of about 165 million, Pakistan is the second largest populous Muslim country after Indonesia.

[29] The Islamization measures included the elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT in July 1979 and that of the commercial banks during January 1981 to June 1985.

Table 4: Chronology of Islamic Banking in Pakistan

Date	Description of Developments
1949	The Objective resolution was passed by the National Assemble of Pakistan that declared Islamic as the State Religion of the country
1977-78	Steps for Islamization of banking and financial system of Pakistan were started
July, 1979	Elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT
1981-85	Elimination of interest from the operations of nationalized commercial banks
June, 1980	Permit issuance of a new interest-free instrument of corporate financing named Participation Term Certificate (PTC)
January, 1981	Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank (Bank of Oman)
March, 1980	Financing of import and inland bills and that of the then Rice Export Corporation of Pakistan, Cotton Export Corporation and the Trading Corporation of Pakistan were shifted to mark-up basis
July, 1981	banks were allowed to provide finance for meeting the working capital needs of trade and industry on a selective basis under the technique of Musharaka
April, 1985	All finances to all entities including individuals began to be made in one of the specified interest-free modes
1985	The Eighth Amendment of the 1973 Constitution, adopted by the National Assembly, made room for creation of the Federal Shariat Court (FSC).
November, 1991	The procedure adopted by banks in Pakistan since July 1 1985, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared un-Islamic by the Federal Shariat Court (FSC)
January, 2000	The Commission for Transformation of Financial System (CTFS) was constituted in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor State Bank of Pakistan
September, 2001	It was decided that the shift to interest free economy would be made in a gradual and phased manner and without causing any disruptions
December, 2001	The State Bank of Pakistan issued detailed criteria for establishment of full-fledged Islamic commercial banks in the private sector
January, 2002	Al Meezan Investment Bank received the first Islamic commercial banking license from SBP
March, 2002	Meezan Bank Limited (MBL) commenced full-fledged commercial banking operation
June, 2002	Meezan Bank Limited had a network of 5 branches all over the country
December, 2004	2 full-fledged Islamic Banks and 7 conventional Banks with Islamic window operations
December, 2005	2 full-fledged Islamic Banks and 9 conventional Banks with Islamic window operations
December, 2006	6 full-fledged Islamic Banks and 12 conventional Banks with Islamic window operations

Source: State Bank of Pakistan

There were no specialized IFIs in those days and the Islamization steps were taken only on macro level but now we have 6 IFIs which makes 12.5% of the total banks in the country (Table 5). Regulatory measures were taken for the Islamization of the financial transactions.[30] However, these measures and the so-called Islamic Financial transactions were declared un-Islamic by the Federal Shariat Court (FSC) in November 1991 that led to further adjustments thereafter[31].

Table 5: Financial Institutions in Pakistan

Description	Number	Number in %
Government Owned Banks	9	18.8
Privatized Banks	4	8.3
Private Banks	19	39.6
Foreign Banks	6	12.5
Development Financial Institutions	7	14.6
Non Member Banks	3	6.3
Total Banks in Pakistan	48	100.0
Full Fledged Islamic Banks (Out of total)	**6**	**12.5**
Conventional Banks with Islamic Window Operations (Out of Total)	**12**	**25.0**

Source: State Bank of Pakistan

[30] The legal framework of Pakistan's financial and corporate system was amended on June 26, 1980 to permit issuance of a new interest-free instrument of corporate financing named Participation Term Certificate (PTC). An Ordinance was promulgated to allow the establishment of Mudaraba companies and floatation of Mudaraba certificates for raising risk based capital. Amendments were also made in the Banking Companies Ordinance, 1962 (The BCO, 1962) and related laws to include provision of bank finance through PLS, mark-up in prices, leasing and hire purchase.

31 The procedure adopted by banks in Pakistan since July 1 1985, based largely on 'mark-up' technique with or without 'buy-back arrangement', was declared un-Islamic by the Federal Shariat Court (FSC). The Govt. of Pakistan and 67 companies filed appeals against this decision with the Sharia Appellate Bench (SAB) of the Supreme Court. The SAB gave its landmark decision banning interest in all its forms and by whatever name it may be called. Thus Pakistan became the first Muslim country to officially declare modern bank interest as ar-riba, declared haram by Qur'an. The court also specified a step by step approach to rid the country of the evil of interest. As a consequence of this judgement, certain laws ceased to take effect from 31 March 2000, some other laws from 31 July 2000, and all other laws permitting or condoning interest from 30 June 2001. The Federal Government of Pakistan and certain banks and financial institutions filed 67 appeals against this judgment in the Shariah Appellate Bench of the Supreme Court. The Shariah Appellate Bench consisted of 1) Mr. Justice Khalil-ur-Rahman, 2) Mr. Justice Munir A Shaikh, 3) Mr. Justice Wajeehuddin Ahmad, and 4) Maulana Justice Muhammad Taqi Usmani.

This decision made Pakistan as the first Muslim country to officially declare modern bank interest as ar-riba, declared haram (prohibited) by Qur'an. Consequently, serious regulatory changes were brought about in the country which led to the tremendous growth of the industry and Islamic banks were encouraged to start operations in Pakistan[32]. Islamic finance in Pakistan now seems to be making its way towards providing the Islamic investors an adequate alternative to the conventional finance as the Islamic banks have now captured almost three per cent of the total banking industry of the country. In December 2006, the market share of IFIs in Pakistan represents 2.9% of the total assets of the financial industry of the country which has grown from 0.5% in 2003[33]. The Islamic financial industry of Pakistan manages a total of PKR 118 billions as of December 2006. Total deposits are PKR 83 billions and financing & investments are PKR 72 billions (Fig. 7)[34].

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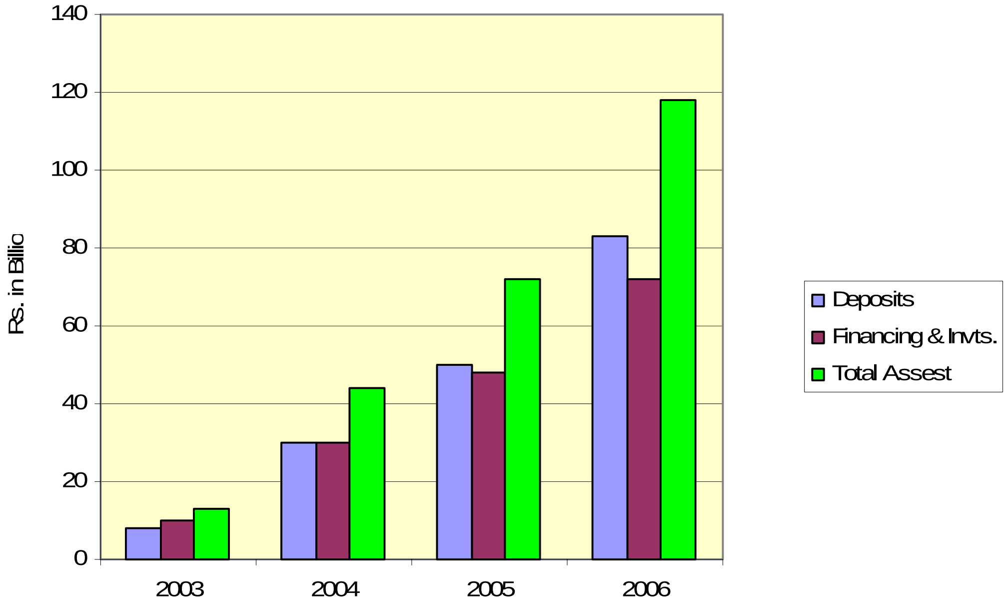
[32] The Commission for Transformation of Financial System (CTFS) was constituted in January 2000 in the State Bank of Pakistan under the Chairmanship of Mr. I.A. Hanfi, a former Governor State Bank of Pakistan. A Task Force was set up in the Ministry of Finance to suggest the ways to eliminate interest from Government financial transactions. Another Task Force was set up in the Ministry of Law to suggest amendments in legal framework to implement the Court's Judgment. The CTFS constituted a Committee for Development of Financial Instruments and Standardized Documents in the State Bank to prepare model agreements and financial instruments for new system.

[33] The 2006 Islamic Banking Bulleton of the State Bank of Pakistan shows that the share of Islamic Banks in total deposits of the banking industry of the country grew from 0.4% to 2.8% and share in financing grew from 0.5% to 2.4%. The average annual growth in the total deposits of the Islamic Banking industry in the period from January 2003 to December 2006 is 136% and the same growth in total financing and investments is 103%. The average annual growth in the total assets in the Islamic Finance Industy of Pakistan is 122% in the period from December 2003 to December 2006.

[34] PKR stands for Pakistani Rupees. The current exchange rate with dollar is PKR 60/$.

Fig. 7: Growth of Islamic Banking in Terms of Deposits, Financing and Investments and Total Assets. (All the figures are as of December)



Source: Islamic Banking Bulliton, State Bank of Pakistan, Feb, 2007
Note: The exchange rate of Rs. and US$ is Rs. 60/$

The distribution of Islamic banking products in Pakistan shows the same trend as in the global Islamic financial industry; Murabaha has been the most prominent Islamic banking product in Pakistan which comprises of about 40% of the total financing products (Fig. 8)[35]. The second most promising product is Ijara; about 30%.

The Non-Performing Loans (NPL) of the Islamic finance industry are only 1.2% of the total advances which shows a very high quality of advances[36].

The number of licensed Islamic banks is now six.[37] Some of these banks are already

[35] The Mudaraba mode of financing is not present in Pakistan. Also Qarz-e-Hasna is almost 0%.

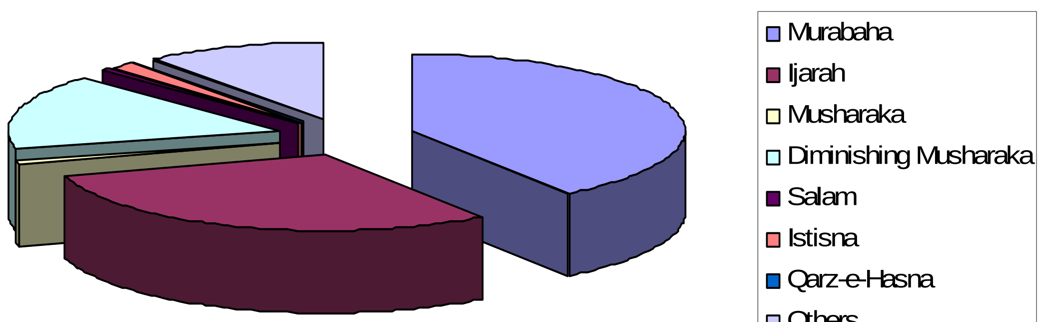
[36] The other Asset-quality Ratios also show a very good position of the industry; Net NPL to Net Financings ratio is 0.3%, Net NPL to Total Assets ratio is 0.2% and Net NPL to Total Capital ration is 1.4%. These ratios are much better that the conventional financial industry of the country. See the February 2006 Islamic banking Bulliton of the State Bank of Pakistan`

[37] There was only one Full-fledged Islamic bank and 3 conventional banks with Islamic banking window operations in December 2003.The total number of branches that offer Islamic finance facilities is 150. This number has grown from 17 in December 2003.

operating widely throughout the country. Additionally, 150 branches of twelve conventional banks are also providing exclusive Islamic banking services to their customers.[38]

The growing Islamic banking industry of Pakistan has become one of the priority destinations for the International banks like Citybank, Standard Chartered and Japan Bank for International Cooperation (JBIC). JBIC has announced to launch Shariah-compliant Sukuk bonds in Pakistan to tap the potential for the growth of Islamic banking.[39]

Fig. 8: Break-Down of Islamic Financial Products in Pakistan



Istithmar Bank, partnered with AIG Global Real Estate, has announced to invest in

[38] Islamic Banking Bullitton, State Bank of Pakistan, Feb, 2007

[39] "The JBIC is looking for Islamic funds and they are planning to enter Pakistan in February next year," Dr Imran Usmani who is one of the counsels of the Shariah Board of the JBIC told. Saudi Arabia could be their first destination for launching of these bonds, he said and added Malaysia was also on their target and Pakistan could be third destination. For this purpose an MoU was signed between the two in Tokyo on May 25, 2006. The JBIC also appointed two other renowned Shariah scholars as members of its Shariah Counsel Group.

Pakistan and other emerging markets.[40] Also, First Dawood Islamic Bank Limited is licensed as the sixth Islamic bank in Pakistan; sponsored by the First Dawood Group, Bank Islam Malaysia Berhad, Unicorn Investment Bank and Islamic Corporation of the Private Sector (ICD)- an arm of the Islamic Development Bank.[41]

3. The Islamic versus the Conventional Financial Systems

The Islamic economic principles that govern the Islamic financial system form a branch of Sharia - a set of rules that governs every aspect of Islamic life. Sharia has a well-established backbone of a sound financial system including government taxation, banking, international finance, etc. It prohibits some of the common practices in the conventional finance. For example, interest on loan is prohibited, and this is the major and significant difference between the Islamic and the conventional financial systems. The rationale is that money is just a medium of exchange and has no intrinsic value, and hence it should not be traded like other commodities but should be used to facilitate the trade of commodities. As a result, a large part of Islamic banking involves profit and loss sharing or equity participation in the forms of Murabaha, Mudaraba and Musharaka, where there is no pre-determined interest and the investor is liable to lose his/her invested capital if the borrower loses.

Although ban on the receipt and payment of interest is the nucleus of the Islamic financial system, the system is also supported by other principles of Islamic doctrine advocating risk sharing, individuals' rights and duties, property rights, sanctity of contracts, and great emphasis on ethical business practices. There are six basic principals

[40] Khaleej Times, September 18, 2006
[41] Daily Times, May 23, 2006

of Islamic Finance;

First, transactions have to be trade related - i.e., there should be some underlying commercial need. Second, the flow of funds should create value to the economy and add to the social welfare of the society. Third, contractual obligations and the disclosure of information are upheld as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard. Sanctity of contracts is a very important feature of Islamic financial and social system.

Fourth, investments in businesses that create social evils or destroy social norms are not allowed.[42] Fifth, Gharar, which means excessive uncertainty, is not allowed. Sharia allows reasonable level of uncertainty embedded in most investment opportunities, but prohibits investments if the degree of uncertainty is unusually high[43]. The prohibition of Gharar is often used to justify prohibition of such conventional financial practices as speculation and financial derivatives. Sixth, exploitation of any party due to weak position or weak bargaining power is prohibited. Sharia emphasizes that every transaction should be just to all the participating parties. One party should not be benefited at the expense of the other. Both parties should be happy and satisfied after the transaction.[44] Similarly, unjust distribution of income between the depositor and the financial institution is also prohibited.

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[42] For example; investment in pornographic, tobacco, alcohol and weapons (which is not in the control of the state) is prohibited. These businesses harm the society and create social disorders. Investment in pork related businesses is also prohibited because of its ban in Quran.

[43] The sale or purchase of something that does not exist at the time of contract and whose expected quality and quantity cannot be guaranteed is included in the category of Gharar e.g. a transaction on crops (grown in a specified field) next year. Financial options are considered as Gharar by Sharia scholars. Bai Salam is a transaction on goods that do not exist at the time of contract but it is not included in the category of Gharar because its expected quality and quantity can be assured.

[44] In the case of many derivatives contracts, for example, one party gains only when the other party loses, and therefore they are prohibited in Sharia. Similarly, gambling is also included in this category because of this reason.

Sharia allows all those transactions that do not violate its rules, but there are no such restrictions on conventional banks. Almost all of the deposits and loan extensions of conventional banks are based on interest, and CFIs are not required to look as deeper into the investment opportunities from an ethical point of view as the IFIs are required to do. It is not surprising that IFIs are at great disadvantage against their conventional competitors as they face additional restrictions and additional risk due to Sharia. These days, almost all of the conventional financial products have their Islamic alternatives - although not fully Islamic in their true sense, they are quite close. Research in Islamic finance is going on at a good pace and we will see much improvement towards true Islamization of all the conventional financial practices.

As IFIs have to observe additional restrictions in addition to those observed by CFIs, this hinders flow of funds from IFIs to CFIs and vice versa. The purpose of this paper is to find ways that can make such flow of funds easier. In the following section, we develop certain models that meet the above-mentioned purpose.

4. Bridging the Two Financial Systems

Although there are fundamental differences between the Islamic and the conventional banking systems, one may still be able to find some slots for cooperation between them. There have been active efforts to connect the two systems. For example, some large development projects have been funded jointly by international investment banks and IFIs (Table 4). Citibank, HSBC and such other international banks have been actively working with Islamic banks to fund Sharia-complaint projects. A recent example is the Petro-Rabigh project (the “Rabigh Project”), jointly financed by APICORP, Bank Al

Bilad, Calyon, Citibank, Islamic Development Bank, Gulf International Bank, Riyad Bank and SABB.[45] Similar cases flourish where projects have been jointly financed by Islamic and conventional banks (Table 4).

Table 4: Examples of Sharia-complaint projects Jointly Financed by Islamic and Conventional Banks

Country	Project Financier	Total Amount (USD M)	Year	Original Currency	Project Manager
Europe	Heitman; UBS Real Estate, Arcapita	**814.90**	2004	**EUR**	NA
UAE	Arcapita; HSBC	**500.00**	2004	**USD**	Dubai Sports City LLC
Bahrain	Arcapita; HSBC	**300.00**	2004	**USD**	Bahrain International Golf Course Company
Europe	Arcapita; Bank of Scotland	**281.90**	2003	**Euro**	Shurgard Self Storage
USA	Arcapita; Fannie Mae, Bank of America, N.A., Bank One, N.A. and GMACCM	**417.40**	2002	**USD**	Sunrise Third Senior Living Holdings LLC
USA	Arcapita; Prudential Insurance Company of America	**222.40**	2002	**USD**	Sunrise Second Assisted Living Holdings LLC
USA	Arcapita; Freddie Mac	**143.70**	2000	**USD**	Second Multifamily Properties LLC

*Arcapita is the first Islamic Investment Bank

Source: IFIS (Islamic Finance Information Services)

As one can easily see, cooperation between Islamic and conventional systems has been achieved mostly for the purpose of funding large-size development projects. We strongly believe, however, that there are other areas of potential cooperation between the two

45 For a detailed description of the Rabigh Project, see the article "Islamic Project Finance in the Kingdom of Saudi Arabia" by Craig, Al Sheikh, Kamal and Al Sudairy (White & Case, September 2006). Also see the Q & A with White & Case´s Craig Nethercott, Mohammed Al-Sheikh and Christopher on "Islamic Financing Spreads in the Middle East " (White & Case, March 28, 2006)

systems in countries (like Pakistan) developing at a faster rate and local CFI's are unable to finance the economic expansions. Many IFIs today have a lot of funds because of the petro-dollars and the increasing demand for Islamic banking products from Muslim depositors, but their investment opportunities in home countries are rather limited. Most IFIs may lack the market acquaintances to serve such countries, but there may exist local CFIs that come across some good investment opportunities which, even though the risk-return characteristics are not particularly suitable for the CFI's risk appetite, may be acceptable to the IFIs. It may turn out that the two institutions belonging to different financial systems can work together to avail those opportunities.

It is the differences between the two systems that may provide ample opportunity for cooperation: Due to Sharia's prohibition on interest, IFIs become more tolerant to equity-type risk than their conventional counterparts with fixed-income-type funding. For example, a conventional bank may not be willingly to invest in equity-type claims if it has to pay a fixed rate of interest to the depositors, because the mismatch in risk types between its assets and liabilities would create huge burden on the management. There are many investment opportunities, however, where the entrepreneurs prefer equity-type funding in order to avoid hard commitments of cash outflows. An Islamic bank may not face a problem similar to a conventional bank because the nature of an Islamic deposit which is more like a partnership contract than credit relationship. Hence there is an opportunity for the CFIs to work as agents for intermediation in equity investment of IFI in the enterprise. In some cases, the entrepreneur and the Islamic bank may find it better to leverage the funding in order to increase the expected return of the investment. In this case, the two FIs may agree on a deal structure similar to project financing. In what follows, we explore some of the promising deal structures that may facilitate the cooperation and the flow of funds between the Islamic and the conventional financial systems.

4.1 Project Financing Model:

Project financing is probably the most significant investment activity of the present-day Islamic finance industry. Cooperation between Islamic and conventional banks is already quite active in this area. This paper presents a special case of Project Financing Model (Fig. 3). The various steps of the model are described here.

Step 1: Either the conventional or Islamic bank finds an investment opportunity that needs equity as well as bond financing[46]. The two banks negotiate with each other to establish an SPV. [47]

Step 2: The two banks invest their funds in the SPV. The conventional bank has a bond-type investment in the SPV and the Islamic bank becomes the major shareholder of the SPV. However, the bond type investment must not exceed 50% of the total financing otherwise it will violate the Sharia screening rules.[48]

Step 3: The SPV invests funds in the project in two different modes of financing - equity and bond. The equity part of the project is financed by the Islamic bank while the bond part is financed by the conventional bank.

[46] According to Mufti Mushtaq, the funds of the conventional banks are mostly what we call the prohibited money except the money that comes form the current accounts. In the case of an SPV or any other joint venture, the portion of the prohibited money must not exceed 50% of the total financing of the SPV.

[47] SPV (Special Purpose Company) is a temporary legal company created for a specific purpose - e.g. carrying out a project. The SPV is dismantled as soon as the purpose is achieved or the task is abandoned. According to Mufti Muhammad Mushtaq Ahmad, SPV is generally used in project where securitization is intended, Pooling of investment doesn't require the formation of SPV. It is simply Musharaka Project. and Musharaka Project doesn't require establishment of SPV.
but it is a nice tool if the two institutions want to pursue different project financing on going-concern bases.

[48] According to Mufti Mushtaq, the portion of the prohibited money must not exceed 50% of the total financing of the SPV. Some Sharia scholars say that the prohibited should not exceed 30% of the total financing.

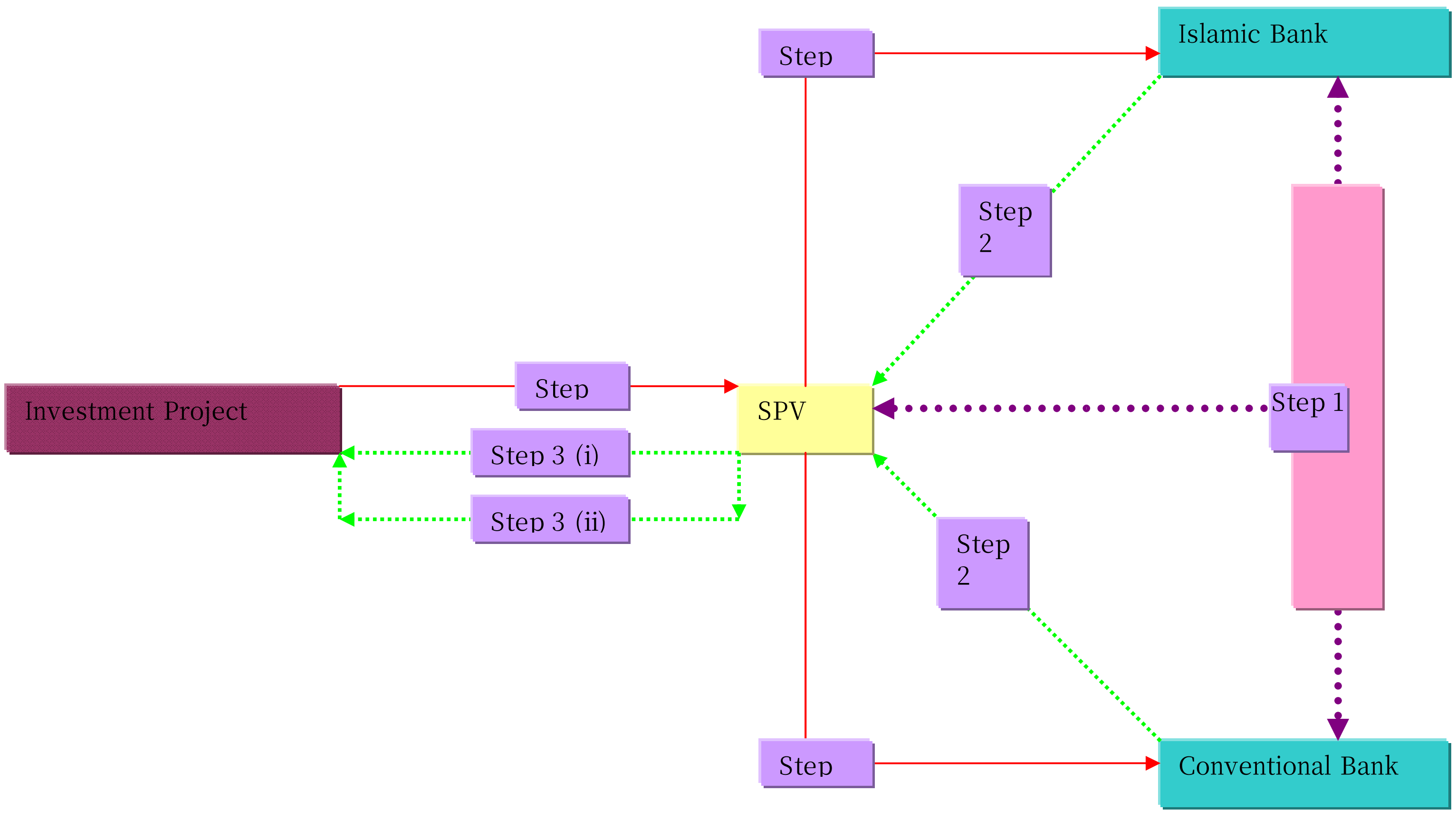
Step 4: Profit of the project comes to the SPV. This profit includes two kinds of income; bond income and equity income.

Step 5: The SPV pays the fixed income to the conventional bank and the remaining profit is given to the Islamic Bank. [49]

Project financing has been a key area of investment for Islamic banks. Many Islamic banks have already been very active in working with conventional banks in this field. It is important, however, to note that the interactions between the two systems have been limited only to a narrow area of project financing. It is worth trying to find alternative channels of cooperation. The following deal structures, which are variations of the project financing model, may serve such purposes.

[49] From Sharia point of view, it is more desirable that the two financial institutions make equity investments and share the profit and loss of the SPV.

Fig. 3: Project Financing Model



4.2 Agency Model:

There may exist, in Pakistan, some attractive Sharia-complaint investments opportunities that the Islamic bank may want to invest in but lacks necessary competencies. For example, an Islamic bank in the Middle East may wants to invest in the Pakistani market but finds it lacks proper market acquaintance. It may find it better to find a local partner. Similarly, a lot of potential Sharia-compliant investment opportunities may exist in the Korean, Chinese or other markets where Islamic banks have little or no experience[50]. In these cases, an agency relationship between an Islamic bank and a local conventional bank can be established whereby the conventional bank acts as an agent of the Islamic bank. A simple model is given in Figure 5. The step by step explanation of the model is as follows:

Step 1: A Sharia-compliant investment opportunity approaches the conventional bank for financing. The bank may have the expertise to manage this investment opportunity but does not have enough capital to finance the project, or it finds the risk characteristics of the investment opportunity is not properly aligned with its risk-averse nature and therefore it does not want to grasp it at its own risk. The conventional bank then approaches a local or foreign Islamic bank for financing the business whereby it agrees to work as an agent of the Islamic bank. Detailed terms and conditions are set at this stage. The most appropriate approach is to have a profit sharing ratio[51].

[50] Kuwait Finance House Malaysia started to sell Islamic bonds worth US$ 200 million for a Chinese firm in November 2006. This is said to be the first Islamic Bond issued for a Chinese company (See Islamic Finance News, 22nd November, 2006)
[51] A fee-based contract can also be signed whereby the conventional bank gets fees for its services as an agent.

Step 2: The conventional bank establishes an SPV which is a kind of temporary asset management company setup only for the execution of the specific investment project. The SPV vanishes as soon as the investment is wrapped up.

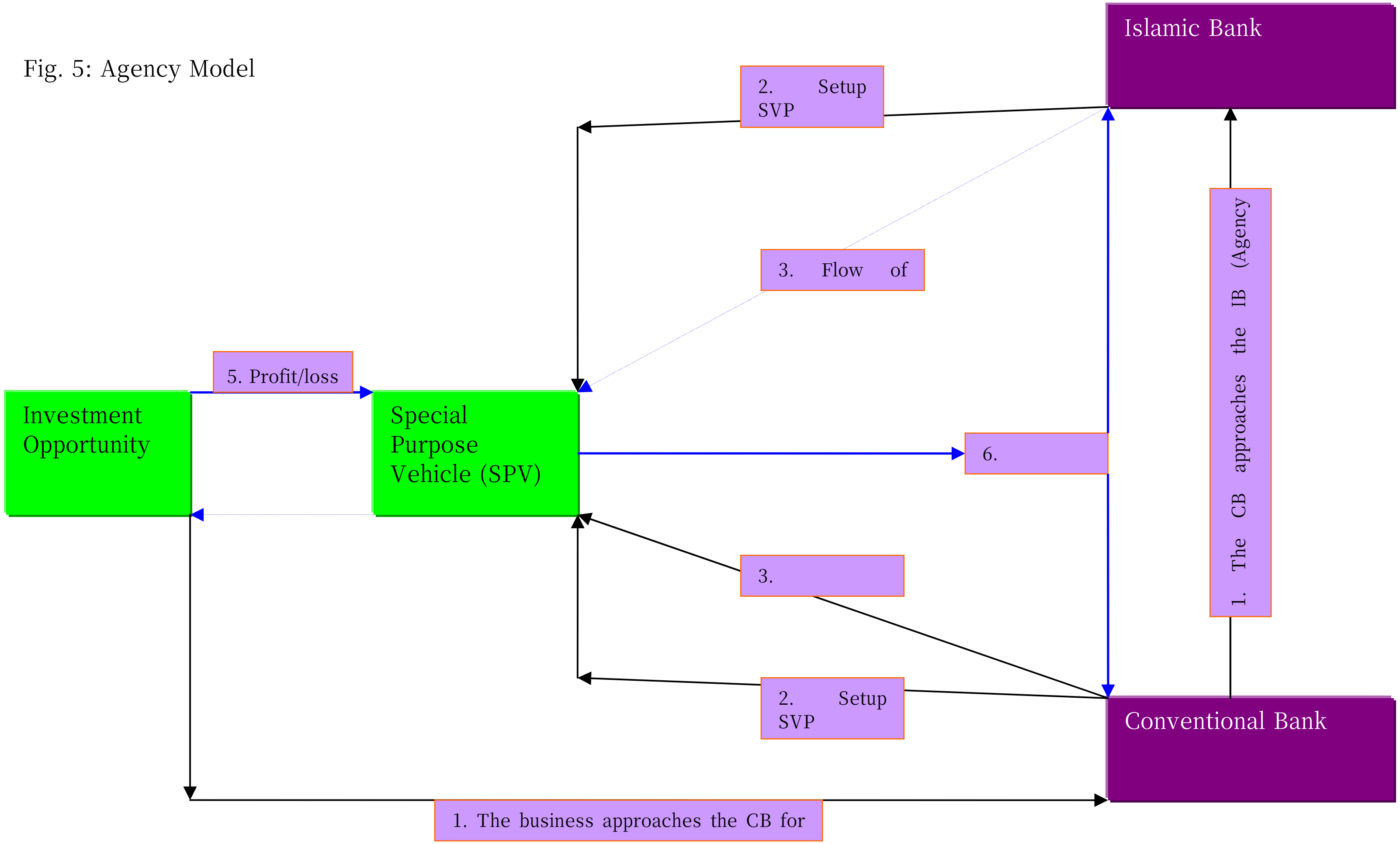
Step 3: The Islamic bank provides funding according to the terms and conditions of the contract.

Step 4: The SPV invests the funds in the business and supervises it throughout the course of the term of the agreement. The SPV is managed by the conventional bank by providing its management expertise.

Step 5: The profit/loss from the business comes to the SPV.

Step 6: If the income of the SPV is positive, it is shared between the Islamic and the conventional banks according to the terms and conditions of the contract. The residual value of the SPV will be returned to the Islamic bank or shared between the two institutions if it is agreed upon in the contract. In case of losses, the monetary loss will be born by the Islamic bank and the conventional bank gets no reward for its services.

Fig. 5: Agency Model



4.3 Loan Restructuring Model:

Acquisition of existing loans from conventional banks or of securities backed by such loan contracts may not be a good investment alternative for an IFI because an interest-bearing loan is strictly prohibited by Sharia. This means that the growing market for loan restructuring is not accessible to Islamic finance.[52] The Loan Restructuring Model (Fig. 6), presented in this paper, can well be applied by a conventional bank suffering from too much below-investment-grade loans to restructure their existing loan portfolio into an equity-like contract and thus attracts Sharia-complaint funding from Islamic banks.

Step 1: A company that a conventional bank had already advanced loan to, begins suffering badly from shortage of cashflows due to the interest payment. The bank believes that the company would generate enough cashflows in the long run, but is not willing to sit on a non-performing asset for an extended period.

Step 2: The conventional bank approaches the Islamic bank for sharing the company's long-term cashflows.

Step 3: The CFI, IFI and the target company discuss the terms and conditions of loan restructuring. When they reach to a consensus, the previously advanced loan to the company is restructured into two parts; equity and debt. The equity portion is taken by the Islamic bank or shared by the two banks, and the conventional bank takes only the debt part.

Step 4: The conventional bank gets fixed interest out of the cashflows that the company generates. The interest should be much smaller than had been specified in the original

[52] After the Asian financial crisis of the late 1990s, the market for loan restructuring grew very fast in certain countries, especially countries like Korea. It is said that many western financial institutions that participated in that market at the early stages had achieved a very high level of return on investment.

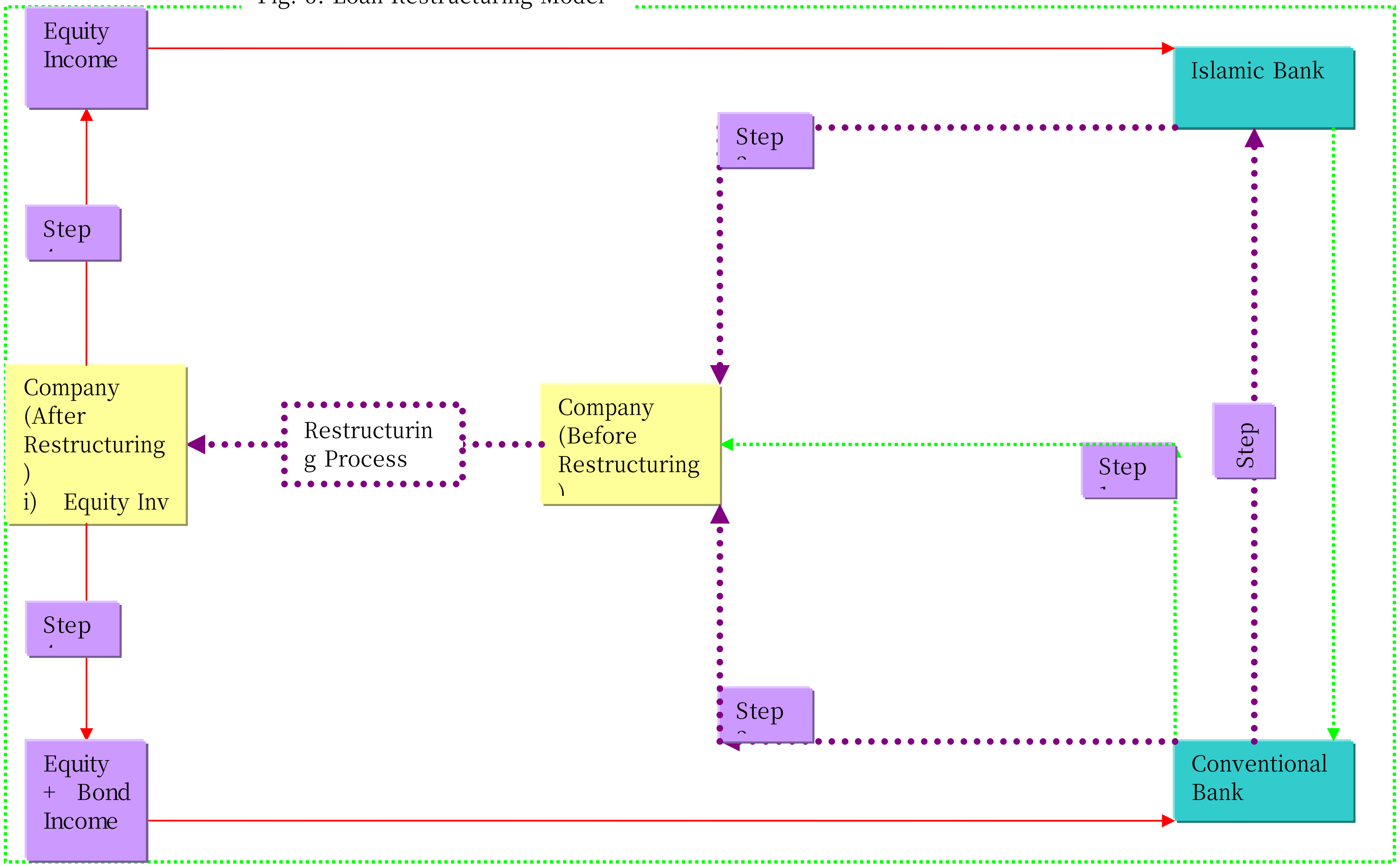
loan contract.[53] If the company declares profit after paying the debt off, the Islamic bank takes its share in the equity profit according to the terms and conditions of the contract.[54]

In many countries in Asia including Korea, commercial banks have ample experience in loan restructuring due to the financial crisis in the late 1990s. It is expected that the market for loan restructuring in Pakistan, China and India would grow very fast. Even though many Korean banks and other specialized institutions such as KAMCO (Korea Asset Management Corporation) plan to enter this market, they either do not have enough financial resources or fear the high credit risk in these markets. Some Islamic banks which do not have to receive a minimum level of interest may find the opportunity worth the risk and thus a mood of cooperation can be found.

[53] When a loan is restructured due to the issuing company's financial distress, interest burden of the company is lightened in two ways: The principal of the debt portion is reduced to only a portion of the original loan, and the interest rate may also be reduced. The original lender usually accepts a lower interest rate because small loss in interest is better than sitting on a bad loan.

[54] In many loan restructuring schemes equity investors receives payoffs only after the debt is paid off. It is possible, however, to allow dividends before the principal is paid off as long as the company generates enough cashflows to convince the debtholders that the debt would ultimately be paid in full.

Fig. 6: Loan Restructuring Model



4.1 Implications to Pakistani Banking Industry

Pakistan has been exhibiting tremendous economic growth for the past few years (Fig. 7). It was the second fastest economy of the world in 2005 due to an 8.4% growth in GDP. Therefore a large number of development projects are underway in Pakistan[55]. These projects are attracting foreign companies and investments to the country[56]. A few examples of such projects are; the Gawadar Free Port, Gawadar Port City, Motorway Networks and road infrastructure. The existing conventional banks in the country are unable to finance all these projects either due to shortage of capital or the associated risk. In order to tap this market a number of Islamic banks from the gulf have started operations in Pakistan[57] but they lack the necessary market experience therefore there is an ample need for cooperation between the Islamic and conventional banks in Pakistan in order to tap a good destination market for profitable investments.

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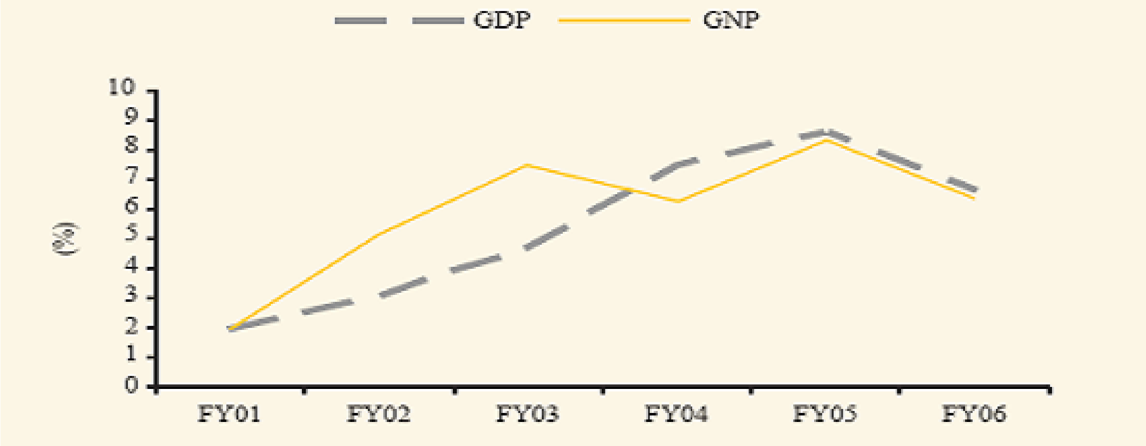
[55] According to the Ministry of communication of Pakistan, currently US$ 8 billion infrastructure projects are underway in Pakistan that will be completed by 2012

[56] CIDB Malaysia and the National Highway Authority (NHA) of Pakistan Monday sealed an agreement worth US$102.6 million to build two highways in Pakistan. To date, IJM Corporation Bhd is the only Malaysian company involved in infrastructure construction in Pakistan. It is building an elevated expressway along Shahrah-E-Faisal from the Quaidabad Intersection to Jinnah Bridge in Karachi

[57] One example of such banks is the Dubai Islamic Bank that started operations in Pakistan in late 2006.

Fig 7: Trends in Economic Growth in Pakistan



Source: National Bank of Pakistan

The models developed in this paper can be applied to inter-bank cooperation between Islamic and conventional banks in Pakistan. As there already exist full-fledged Islamic banks in Pakistan, the suitable model here is the project finance model especially for the development projects currently underway and upcoming. The loan restructuring model can also be applied for starting the dead industries that have been closed during 1993-04 due to shortage of capital.[58] The agency model can be used by those gulf-based Islamic banks that don't have operations in Pakistan. Further research on putting these models into more local context will add to more fruitful investment deals in Pakistan.

[58] Pakistan is one of the top producers of the textile raw material but textile industries were closed during 1993-04 due heavy tax and other financial burdens.

5. Summary and Conclusion

Islamic Finance has become a very significant part of the global financial industry. It has come a long way and is there to stay. Although it is still much smaller than the conventional financial industry, it is significant enough not be ignored anymore. Keeping in view the growing Islamic finance industry and its attractive market potential, the conventional banking institutions have also established ties with Islamic banks to finance large development projects. This cooperation between Islamic and conventional banks till today is mostly limited to a narrow area mainly because of the fundamental differences between the two systems. But there exist a number of other potential ways that can make this cooperation possible in a broader sense.

Project financing is the area where the cooperation already exists and is very active. In this paper, I have developed several variations of such deal structures which, I believe, would create ample opportunities for cooperation between the Islamic and the conventional financial systems, especially in countries whose economies are growing too fast for the domestic CFIs to find enough creditors that are willing to expose their money to riskier-than-deposit investment opportunities. The Loan Restructuring model can be used by both the banks for sharing the long-term cashflows of a company that are experiencing difficulties in servicing existing loans from the conventional bank. The Agency model can be used for establishing an agency relationship between the Islamic and the conventional banks where the conventional bank will have to work as an agent of the Islamic bank. There is a huge market potential for such joint cooperation models both in established economies like Japan and Korea and in growing economies like Pakistan.

While much research efforts have been devoted to Islamization of conventional financial products or to introducing such products to non-Muslim investors, potential for cooperation between the Islamic and the conventional financial systems has not been actively studied. We believe that many of the deal structures can easily be adopted in order to fill the gap in risk tolerance between entrepreneurs and domestic bankers. Further research effort in this direction will prove valuable for the expansion of the Islamic financial systems to the non-Muslim world.

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