

## **Ethical Banking: the Islamic View**

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### **Abstract**

The twentieth first century has witnessed resurgence in the observance of fundamental Islamic practices around the world. At a time when most academic sociology would predict the decline of religions observance as science progresses, in fact, religious observance and especially fundamentalist versions are increasing. The paper examines the foundations of Islamization in the global financial sector. We present a basic theoretical understanding of the concept of Riba. We explore the basic principles of Islamic banking, the tools of interest free banking and how Islamic banking can be implemented in a hyper-competitive environment. In conclusion we suggest that the principle of Zakat may have a key role to play.

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## **1. Introduction**

Islamization varies dramatically across countries with Muslim populations. The Islamic Republic of Iran and Pakistan are at one extreme, where the entire financial sector has been made officially Islamic according to their central banks.

Malaysia, Saudi Arabia, and some other Arab countries have developed a hybrid financial system where Islamic banks coexist with regular financial institutions, and the monetary authorities of those countries regulate both types of financial institutions.

This increase in the practice of Islamic banking transformed Islamic economics from a sub-field of Islamic jurisprudence and comparative systems, into one which interacts positively with mainstream economic theory.

Islamic banking is a growing phenomenon, which came into existence to satisfy the financial needs of devout Muslims who observe the prohibition of interest-based transactions. Many economists<sup>1</sup> have studied the macro-economic properties of banking institution in the framework of an isolated and ideal Islamic economy. In the age of integrated global financial markets, the instantaneous transformation of an entire financial sector to profit-and-loss sharing is very unlikely: so what is the outlook for Islamic banking?

In this paper we approach the question in three stages. Firstly, we sketch the principles underlying the neoclassical theory of interest, examining the motivations it implies on the part of savers and investors. Secondly, we present an outline of the principles of Islamic banking and the tools of interest -free banking. Thirdly, we compare the two approaches, and examine the compatibility of the Islamic approach with the current business and financial environment.

Khan (1986) has noted that the abolition of interest-based transactions is not a subject alien to Western economic thought. Fisher (1945), Simons (1948), and Friedman (1969) have argued that the current one-sided liability, interest-based financial system can be fundamentally unstable. There are many such examples; the German hyperinflation of the 1920s, post war hyperinflation's in South America, oil shock inflation's in Europe of the 1970s; and banking crises in Japan, East Asia, California, the BCCI debacle in the 1980s, and so on.<sup>2</sup> The occurrence of crises is the result of a complex of factors emanating from overexuberance, greed underestimation of risk, overexposure, currency failures, asset depreciation, faulty regulation, illiquidity, macroeconomic shocks.

Zarqa (1983), Khan (1986), Umer Chapra. M., (2000) El-Gamel .A.M, (2000) and Abdul Gafoor. A. L.M (1997) a number of papers that followed have illustrated the macroeconomic stability that can from a profit and loss sharing system, which an Islamic form of banking would replace interest-based transactions that characterize Western transactions.

But the Islamic view has its critics: and not only among mainstream economists. Perhaps the strongest condemnation of profit/lost sharing in the literature that is fundamentally to an Islamic approach. is Ahmad (1992):*“The sad reality is that though every one concedes that Islam prohibits interest, there is not a single Muslim country which is running its financial institutions without resorting to interest. The fact is that no one knows how to do it, and when political pressure mounts, they can only resort to some kind of subterfuge... It is not clear whom we are cheating...The worst part of the story is that Islamic economists, as a body in their International*

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<sup>1</sup> Khan, 1995, Ahmed, 1992, Umer Chapra.M, 2000, and Abdul Gafoor. A.L.M, 1997

<sup>2</sup> The Economist December 31<sup>st</sup> 1999

*Monetary and Fiscal Conference held in Islamabad in 1981, gave their unreserved approval to this arrangement. So far this is the best that Islamic economics has to offer, viz., change the name of interest and you have abolished interest”.*

Even though the Islamic banks have attracted a great deal of enthusiasm and support, they have also been subject to a number of other criticisms. These are related either to their inability to come up to standard performance expectations, to the fallibility certificates of their Islamic credentials. One of these criticisms is their inability to get away from the trappings of conventional banks.<sup>3</sup>

The lending activities of Islamic banks are confined primarily to the secondary modes: financing short-term trade and lease operations of large and well-established firms and corporations who get credit facilities from both conventional and Islamic banks.

They do not seem to have played any significant role in financing small and medium scale businesses, farmers, industrialists, or craftsmen, or providing venture capital.<sup>4</sup>

While they mobilise resources from the Muslim countries, a substantial part of their financing goes to large, *triple A* corporations in the West, thus depriving the Muslim world of the benefit of its own resources.<sup>5</sup> Moreover, the rates of return they charge seem to be closely related to the London Interbank Offer Rate (LIBOR). Therefore, there seems to be a feeling that in egalitarian terms their overall performance is not only not better than that of conventional banks, but may in some respects be even worse<sup>6</sup>.

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<sup>3</sup> This seems to be a general feeling and was expressed by Rodney Wilson Sept 1996, in the following words “ Often it has been a case of adapting and modifying conventional instruments so that they can be seen to be Islamically legitimate.”

<sup>4</sup> See the address of Saleh Kamel while accepting the IDB Award on Islamic Banking for the year 1996, Arab News, 22 October 1997, P. 15.

<sup>5</sup> Homoud, 1994, PP. 75-76; T.Khan, 1995; Khan and Mirakhor, 1994, P.20.

<sup>6</sup> Umer Chapra. M, The future of Economics: An Islamic perspective, The Islamic foundation 2000

## 2. The Islamic Prohibition of Interest

We now go on to discuss prohibition of interest<sup>7</sup> in the Qur'an and Hadith. In the Qur'an is revealed to the Prophet Mohammed (pbuh) and in the sayings of the Prophet Mohammed (pbuh), as well as the juridical inferences and extensions based on those prohibitions.

It is important for the assumptions and objectives of this paper to understand the manner in which the prohibition of Riba was introduced and then established in a heterogeneous economic environment. The first verse in the Qur'an mentioning Riba was revealed in Mecca, and it did not abolish the practice, but echoed the essence of the new testament quote that it does not please Allah, and that true increase with Allah cannot be attained through interest (all translation of meaning here follows Dr. Muhammad Taqu-ud-Din Al-Hilali and Dr. Muhammad Muhsin Khan.): in this connection consider, Ar-Rum (30), verse 39 Part 21

*And that which you give in gift (to others), in order that it may increase (your wealth by expecting to get a better one in return) from other people's property, has no increase with Allah: but that which you give in Zakat (charity) seeking Allah's countenance, then those, they shall manifold increase.*

Then came the prohibition early in the Madina revelations: but again it was ambiguous. Was interest prohibited? Or only exorbitant interest? Consider

Al-'Imran (3) verse 130 Part 4

*'O you who believe! Eat not riba (usury) doubled and multiplied but fear Allah that you may be successful.'*

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<sup>7</sup> It is not surprising in light of this clear prohibition of interest in Judaism and Christianity to learn that the first interest free bank in documented history was established prior to the life of Prophet Mohammed (pbuh). The first interest-free (Islamic?) bank Agibi Bank was established circa 700 BC in Babylonian, and functioned exclusively on an equity basis Baron (1952).

Then, among the very last surahs revealed to the Holy Prophet (phub) in the Qur'an, came the unequivocal and strong prohibition:

Al-Baqarah (2) verses 275-276 and 278-279 Part 3.

*'Those who eat riba (usury) will not stand except like the standing of a person beaten by shaitan (Satan) leading him to insanity. That is because they say: 'Trade is only like riba (usury)'. Whereas Allah has permitted trading and forbidden Riba (usury). Whosoever receives an admonition from his lord and stops eating Riba (usury) shall not be punished for the past: his case is for Allah (to Judge): but whoever returns to Riba, such are the dwellers of the fire they will abide therein'.*

*'Allah will destroy Riba and will give increase for sadaqat (deeds of charity) and Allah likes not the disbelievers, sinners'.*

*'O you who believe! Be afraid of Allah and give up what remains (due to you) from Riba (usury), if you are believers'.*

*'And if you do not do it, then take a notice of war from Allah and his messenger but if you repent, you shall have your capital sums. Deal not Unjustly (by asking more than your capital sums), and you shall not be dealt with unjustly (by receiving less than your capital sums)'*

And some of the sayings of the Prophet (pbuh):

*'A trading, two goods of the same kind in different quantities, where the increase is not a proper compensation'. (Al-Jozayri, 1986)*

According to Abu Hurairah the prophet (pbuh) said:

*'Avoid the seven great destructive sins' of which no. 4 is 'to eat up Riba (usury)'.*

### *The classical theory of interest*

In this short section, setting out the well known interest theory based on Fisher's analysis, we assume that inflationary expectations are zero and focus on the issue of real rates. Our concern is with interest in the neo-classical version as an allocation mechanism, bringing savings into line with investment opportunities, and allocating funds in such a way that projects with a positive net present value can attract funds. This briefly put is the incentive mechanism inherent in neo-classical interest theory. We will not in this paper discuss in any detail, the observation of Hurwicz and others (Groves, Ledyard, Radner, for example) that no perfect incentive mechanism can be demonstrated to exist on the basis of reasonable assumptions about human behaviour. We merely note this impossibility theorem, although it does in itself provide the basis of a critique of all incentive mechanisms.

Given zero interest rate expectations, monetary and real rates of interest will converge: there is no need for a premium for anticipated inflation. So what are the essential determinants of the rate of interest of such a world? The classical economist's answer to this question is summed up in the title of Irving Fisher's book: *The Theory of Interest: As determined by Impatience to Spend Income and Opportunity to Invest It*<sup>8</sup>. Fisher explains that the real interest rate, is the price, which equates the supply and demand for capital. The supply depends on people's willingness to save that is, to postpone consumption<sup>9</sup>. The demand depends on the opportunities for productive investment. For example suppose that investment opportunities generally improve. Firms have more good projects, and so are willing to

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<sup>8</sup>Fisher, I., *The Theory of interest*, Augustus M. Kelley, Publishers, New York, 1965: originally published in 1930.

<sup>9</sup> Some of this saving is done indirectly. For example, if you hold 100 shares of GM stock, and GM retains earnings of \$1 per share. GM is saving \$100 on your behalf.

invest more at any interest rate. Therefore, the rate has to rise to induce individuals to save the additional amount that firm want to invest<sup>10</sup>.

Conversely, if investment opportunities deteriorate, there will be a fall in the real interest rate.

Fisher's theory emphasizes that the real rate of interest depends on real phenomena.

A high aggregate willingness to save maybe associated with such factors as high aggregate wealth (because wealthy people usually save more), an uneven

distribution of wealth (an even distribution would mean few rich people, who do most

of the saving), and a high proportion of middle-aged people (the young do not need to

save and the old do not want to "you can not take it with you"). Correspondingly, a

high propensity to invest may be associated with a high level of industrial activity or

major technological advances, or favourable expectations about the future.

relationship between interest rates and inflation in the US.<sup>11</sup>

Essentially Fisherine theory is a market theory describing the determination of interest rates through the interaction of supply and demand

### **3 Islamic foundations**

*We sent our messengers with clear signs, and sent with them book and balance so that people may establish justice<sup>12</sup>.*

In this section we discusses interest from the point of view of the 7 methods of financing scholar/jurist point of view.

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<sup>10</sup> We assume that investors save more as interest rates rise. It doesn't have to be that way: here is an example of how a higher interest rate could mean less saving: Suppose that 20 years hence you will need \$50,000 for your children's college expenses. How much will you have to set aside today to cover this obligation The answer is the present value of \$50,000 after 20 years, or  $50,000/(1+r)^{20}$ . The higher the  $r$ , the lower the present value and the less you have to set aside.

<sup>11</sup> This probable reflects government policy, which before 1951 stabilised nominal interest rates. The 1951 'accord' between the Treasury and the Federal Reserve System permitted more flexible nominal interest rates after 1951.

<sup>12</sup> Al-Qur'an, 57: 25.

There are hundreds of financial instruments devised by Islamic banks and financial institutions to meet the diverse needs of investors and entrepreneurs. However, all of those instruments derive from seven main methods of financing that are well documented in the juridical literature. Those arrangements are summarized in Table 1

Bai al salam	Contract of sale of goods on a deferred payment basis.
Gharar	An exchange in which there is an element of deception either through ignorance of the goods or the price or through faulty description of the goods.
Bai bithaman ajil	This contract refers to the sale of goods on a deferred payment basis
Ijara (leasing)	A contract under which a bank buys and leases out for rental fee equipment required by its client.
Ijara wa-iqtina (lease/hire purchase)	Very similar to <i>Ijara</i> , except that there is a commitment from the client to buy the equipment at the end of the rental period.
Murabaha (cost plus financing)	This is a contract sale between the bank and its client for the sale of goods at a price, which includes a profit margin agreed by both parties.
Mudaraba (trust financing)	This is an agreement made between two parties: one, which provides 100 per cent of the capital for the project and another party, manages the project using his entrepreneurial skills.
Musharaka (Partnership financing)	This Islamic financing technique involves a partnership between two parties who both provide capital towards the financing of the project.
Qard ul hasan (A benevolent or good loan)	An interest-free loan given either for welfare purposes or for bridging short-term funding requirement. The borrower is required to pay back only the amount borrowed.

**a) Mudarabh** (Silent partnership)

This principle of no pain no gain, no one is entitled to any addition to the principal sum if he does not share in the risks involved. Under this system, one party (the investor) provide the capital, and the other (the entrepreneur) provides his time and efforts Profits are shared on pre-agreed basis but losses, if any however, are wholly suffered by the rabbumal (the investor), and entrepreneur has the sole control of the enterprise's management.

**b) Musharakh** (partnership)

Financing through equity participation is called Musharakh. Here the partners or shareholders use their capital through a joint venture, Limited partnership to generate a profit or loss this will be split between the shareholders according to some agreed pre-formula depending on the investment ratio. There is no fixed formula for profit sharing and each case is dealt with on its own merit.

The partner in Musharakh has the right to co-manage all projects, Unlike the Mudarabh where the entrepreneur has the sole control of the enterprise's management.

**c) Murabaha** (resale contract)

In a Murabaha transaction, the bank finances the purchase of asset by buying it on behalf of its client. The bank then adds a "mark-up" in its sale price to its client who pays for it on a deferred basis. The 'cost-plus' nature of Murabaha sounds very much like the interest into capital gains manipulations of tax-avoiders (Edward's, W 2000). Islamic banks are supposed to take a genuine commercial risk between the purchase of the asset from the seller and the sale of the asset to the person requiring the goods. The bank stands in between the buyers and the supplier and is liable if anything goes wrong. There is thus some form of guarantee with respect to the quality of the goods

provided by the bank to the end user in the strict form of Murabaha title to the goods financed may pass to the bank's client at the outset or on deferred payment.

**d) Quard Hassan** (Good Loan)

Literally a "good loan". This is a loan by which a borrower is obliged to repay the lender the principal sum borrowed on the loan. It is left to discretion of the borrower to reward the lender for his loan by paying any sum over and above the amount of the principal.

**e) Ijara** (Simple leasing arrangement)

Here the banks purchase capital/equipment and lease it out under installment plans to end-users. As in western leasing there may be an option to buy the goods built into the contracts. The installments consist of rental for use and part-payment.

**f) Baisalam** (post delivery sale)

When a manufacturer seeks to finance the production of goods he seeks Baisalam financing. This involves the bank paying for the producer's goods at a discount before they have been delivered or even made. It is thus similar the bankers' Acceptance financing in the west.

**g) Baimuajjal**

It is deemed acceptable to charge higher prices for deferred payments. Such transactions are regarded as trades and not loans. Property financing on such a deferred payment basis is called Baimuajjal. The sale price typically exceeds the spot price of the good by some fixed mark-up, which is negotiated prior to the transaction.

***Discussion***

It is often noted that the first two arrangements Mudarabh and Musharakh in this list have a strict risk, profit, and loss sharing rule, whereas the other four Murabaha, Quard Hassan, Ijara, and Baimuajjal, can easily accommodate a hidden interest rate.

Indeed, Islamic banks commonly use an accounting interest rate for bookkeeping these transactions. It is this practice of renaming interest' that is so strongly criticized by Ahmad (1992). Many Islamic banks attempt early in their operations to conduct Mushrakh and Mudarabh but eventually converge to using Murabha, Baimuajjal, and leasing as the main modes of operation. Those practices are commonly favoured due to the elimination of the risks of enterprise failure, moral hazard, and adverse selection.

Perhaps one of the most damaging criticism is that while relying on the secondary modes of financing they do not seem to be fulfilling faithfully the conditions laid down by the *Shari'ah* for the permissibility of these modes. This criticism mayor may not be right. However, what provides credibility to it is the secretiveness and lack of adequate transparency on the part of these banks about their operations<sup>13</sup>.

A second criticism is that the certificates about their Islamic credentials are issued to them by their own internal *Shari'ah* boards. No one doubts the integrity of the members of these boards, who are highly qualified and well-respected *Shari'ah* scholars. They are, nevertheless, employees or paid advisers of these banks and there is a possibility of conflict of interests.

It is not possible to establish the validity of most of these criticisms until a comprehensive survey of Islamic banks has been undertaken. No such survey has been conducted and may not even be feasible or meaningful unless there is assurance of transparency on the part of these banks. However, those well-informed about the working of Islamic banks feel that, while the banks do deserve a significant part of the blame for their weaknesses, the total blame does not necessarily rest on their shoulders.

Expectations are perhaps too high, and there seems to be little appreciation of the numerous, problems that these banks face while operating in a predominantly interest-based financial environment without experienced know-how, shared institutions, and whole-hearted official support. A major reason for their shortcomings may be systemic, and it may not be possible for them to solve systemic problems in their individual capacity.

Moreover, most of these banks are very small compared with the conventional mega-banks with which they have to compete, and do not have the resources to create a proper enabling environment.

#### **4. Conclusion**

Clearly the principles which prohibit Riba differ markedly from the principles underlying Fisher in interest theory. The logic of Fishers interest theory is concerned with the efficient allocation of resources through time. The interest rate in Fishers analysis indicates time preference on the part of borrowers and lenders. The resultant equilibrium allocation is Pareto efficient when the conditions of the theory are met.

Fisherine theory is based on profit maximizing savers and lenders: not an unrealistic assumption about capital markets based on greed. There are two key points to make in this connection.

The first point about Fisherine analysis is that even in the zero inflation world that we postulated, real expected returns, even in efficient capital markets contain a bubble element. Even if the expected long term value of the bubble is zero (corresponding to an efficient market), the existence of the bubble is testimony to the impact of psychological factors on capital markets. This issue was discussed at length in Keynes major works (Keynes, 1936 for example). Hence irrational exuberance or to put it

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<sup>13</sup> Muzzam. Ali, Januray 1997, P. 6.

another way, greed, is a persistent element in capital markets. This place some doubts on the allocative efficiency of market determined interest rates at any point in time.

This leads to a further more substantive point from the point of view of our paper. We raise the issue not of the accuracy or inaccuracy of the assumption of maximizing behaviour on capital markets. Nor do we question, for the purposes of the paper, the efficiency characteristics of modern capital markets. We focus on the purpose of economic society from an ethical perspective. This is the prime concern of the Islamic approach, and constitutes its fundamental differentiating factor.

Islamic principles of interest are concerned with issues of fairness and justice rather than efficiency narrowly defined. These principles focus on the necessity of sharing risk in a fair and stable society, and upon problems of exploitation in markets where power is asymmetric this is the real usury issue.

Putting aside the penetrating comment by Ahmed (1992), that we noted earlier in the paper about hypocrisy in the current practice of Islamic banks, let us deal with the realm of the ideal. Consider an ideal situation in which Islamic principles of interest were adhered to by a substantial proportion of the world financial system. Allow for the variations in the principle set out in Table 1. What they have in common is a prohibition of usury, or excessive interest rates. Could such an idealized system conceivably survive as a foundation of banking in a hypercompetitive environment? Pure logic would dictate that this is not possible in a profit-maximizing world: that is if *excessive* includes interest rates that reflect high risk situations or situations of capital shortage: both of which would require high interest rates that might be considered usurious. However logic would also predict the decline of religion as a necessary accompaniment to economic progress. Pure logic could not predict the dramatic changes in the world economy that have taken place over the last twenty years

except as an ex-post rationalization. We live in a complex world, in which economic systems from time to time are chaotic. In chaotic systems outcomes are sensitively dependent upon initial conditions – meaning that the only thing that is inconceivable is that dramatic changes will fail to take place in the future. We must expect change. With respect to market capitalism as expressed in the world financial system, some form of regulation of the interest cost of debt is perhaps inevitable. Emerging economies and poor economies will make increasing demands on the worlds resources. What will be the basis of potential reforms? The principle of Riba is ambiguous, both in theory and in practice. We do not consider it a usable concept for the allocation of scarce capital. However the principle of Zakat, the fundamental Islamic principle of fair distribution of income and wealth, has no such ambiguity. This we suggest as a basis for international financial reform.

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