

The Value Proposition of Islamic Financial Intermediation: Some Current Legal and Regulatory Challenges

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Abstract: With the tremendous growth experienced in the Islamic finance industry within the past decade, there is an increasing call for self-evaluation in order to reemphasize the need to realize original value proposition of Islamic financial intermediation in Islamic commercial law. The Islamic finance industry has been criticized by some skeptics that it has skid off the track of its original trajectory envisioned by its pioneers. This paper therefore examines some current legal and regulatory challenges in identifying the original value proposition of Islamic financial intermediation in the modern Islamic finance industry. As an exploratory study, this paper identifies a number of legal and regulatory reforms necessary to reposition the global Islamic finance industry in order to make it more conventionally viable without compromising the fundamentals of Shari'ah. The paper concludes with the need to rekindle the original value proposition of Islamic finance, particularly in countries where Islamic finance is just gaining grounds. It is always good to get things right at the initial stage to avoid some sort of legal and regulatory transplants that are not adaptable to such jurisdictions.

Key words: Islamic finance, law, value proposition, Islamic financial intermediation.

INTRODUCTION

It is important for the stakeholders in the Islamic finance industry to take stock of the increasing legal and regulatory challenges facing the industry. This seems to be the right time to reflect on the recent history of Islamic finance, evaluate the current trends and project the future of the industry. While these issues can be considered from different perspectives including the finance and economic perspectives, these comments seek to focus on the role of law in enhancing the value proposition of Islamic financial intermediation with specific reference to some current legal and regulatory challenges. The broader manifestation of fundamental Islamic principles of equity, wealth creation, redistribution of resources, social justice and social responsibility underpin the value proposition of the Islamic finance industry. It appears the modern Islamic finance industry is prohibition-driven as opposed to the social objective of Islamic commercial transactions as understood in the early days of Islam (El-Gamal, 2007). The original value proposition of Islamic financial intermediation boils down to the question: 'What does Islamic finance stands for?'. Specifically, this paper provides a preliminary analysis on the main value proposition of Islamic finance and its relevance in the sustainability of the Islamic finance industry.

Against the above backdrop, this paper examines the original value proposition of Islamic financial intermediation because without establishing the building blocks of the past one might not be able to strategize for the future. This discourse begins with the definition of Islamic financial intermediation and its basis in the Qur'an. It further discusses the real value of Islamic financial intermediation through reference to the original objectives of Islamic law popularly called *maqasid al-shari'ah*. The legal and regulatory reforms proposed in the paper include social entrepreneurship of Islamic financial intermediation, global integration, an all-embracing Shari'ah compliance paradigm, and the need to have a separate domain of experts of 'law of Islamic finance' who should work very closely with the Shari'ah scholars.

Definition of Islamic Financial Intermediation:

Islamic financial intermediation is a process whereby funds or resources are effectively channeled and synchronized between surplus and deficit agents in accordance with the Islamic modes of financing. The surplus agents may be the investors who are willing to partner with firms (deficit agents) in profitable business venture that would bring about mutual benefits (Khalidi & Hamdouni, 2011). Financial intermediation is the driving force

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of the economy where surplus resources are ploughed to other areas of the economy where there is some sort of deficit in accordance to the principles of Islamic law on commercial transactions (*fiqh al-mu'āmalāt*).

Financial intermediation can be traced to some verses of the Qur'an, which encourage redistribution of resources among the people rather than concentrating them in the hands of a few rich people. The main verse that encourages financial intermediation is Qur'an 59: 7, and it provides:

And what Allah restored to His Messenger from the people of the towns - it is for Allah and for the Messenger and for [his] near relatives and orphans and the [stranded] traveler - ***so that it will not be a perpetual distribution among the rich from among you***. And whatever the Messenger has given you - take; and what he has forbidden you - refrain from. And fear Allah; indeed, Allah is severe in penalty.

Though the verse relates to the distribution of war booty, its import is that wealth is meant to circulate among the rich and the poor –between *surplus* and *deficit*. So, Islamic law requires the surplus in the hands of the few to be distributed to the rich who are deficient in financial resources. The introduction of *zakāt* as one of the pillars of Islam in order to promote redistribution of resources within the state and the encouragement of charitable endowments (*awqāf*) are specifically meant to promote financial intermediation and such institutions are recognized as the early period financial intermediaries within the Muslim society. This was the main function of *Bait al-māl* (Public Treasury) during the period of the Prophet Muhammad (PBUH) and the four rightly guided Caliphs (Hasan-uz-Zaman, 1991).

The Real Value of Islamic Financial Intermediation:

In the quest for a sustainable Islamic finance industry, we need to narrow down what is meant by the real value of Islamic financial intermediation. From the conceptual framework of *fiqh al-mu'āmalāt*, there is emphasis on Sharī'ah compliance of all transactions (Hj. Nawawi, 2009). But this carries with it an extra heavy burden of social responsibility because Islamic law is meant to bring about socio-economic developments. So, social responsibility cannot be totally separated from Sharī'ah compliance. These are two inextricable phenomena that establish the real value proposition of Islamic financial intermediation from the classical period up to the modern time. The Islamic finance industry needs to reconsider its classical origins, reappraise its recent past history and identify areas where it has deviated from the *maqāsid* track in order to re-strategize for the future. The cardinal objective of the Sharī'ah, and all institutions and contractual relations established thereunder, is to promote benefits (*maslahah*) and ward off any form of harm (*darar*) (Kamali 2009; Nyazee 2006). This is the origin of the real value proposition in Islamic finance with specific reference to financial intermediation.

The above understanding of the value proposition of Islamic finance is borne out of the original understanding of *fiqh al-mu'āmalāt*, which is the underlying discipline of the modern Islamic finance industry. Without doubt, the Sharī'ah compliance component of the value proposition is one of the major reasons why potential consumers opt for Islamic finance products in both Muslim-majority and western countries. The 'faith premium' or what others call 'piety premium' has far-reaching effect in the financial decisions made by the consumers regarding the products they choose (Gaffaney 2009; Khan 2012). Unfortunately, this seemingly good 'faith premium' has been negatively exploited by some erstwhile reliable Islamic Finance experts. The ongoing bankruptcy proceedings in Canada against UM Financial are beyond one's wildest dreams of the Islamic finance industry (Alini, 2012). The lack of oversight regulation at certain level within the global Islamic finance industry has resulted in different practices across various jurisdictions that have negatively impacted the industry as a whole. Moreover, after the UM Financial debacle, the image of the industry has been at stake in North America (Oseni, 2012). While the case is still pending in the court, it may be *subjudice* to comment further on the case. But this is definitely the time for stakeholders in the industry to revisit the value proposition of Islamic financial intermediation and reposition the industry on right trajectory.

The value proposition of Islamic finance is different from conventional financial intermediation. When the underlying principles of the two worldviews are closely examined, there are a number of notable differences between the two industries. The value proposition of the conventional finance is geared toward consumer-friendly customer services that are meant to attract more customers with the ingenious objective of profit maximization. On the other hand, though the Islamic finance industry is not averse to profit making, its value proposition is more of bringing benefits to the doorsteps of their customers in a mutually beneficial manner through partnership modes of financing. If the value proposition of conventional finance involves socio-economic benefits for the consumers, there wouldn't be any need for socially responsible investing which is gradually gaining grounds as part of the aftermath of the recent global financial meltdown. The value proposition of Islamic finance, firmly rooted in the *maqāsid al-sharī'ah*, traditionally involves ethical investing and green business. This takes into consideration the building blocks of the modern social investing: ethics, environmental stewardship, consumer protection, shareholder activism, community development, and global development. However, there seems to be a gap between theory and practice, as we witness in the modern practice of Islamic finance.

Meanwhile, apart from the example of UM Financial we briefly alluded to above, there is yet another controversial issue that relates directly to the value proposition of Islamic financial intermediation. At the consumer level, one may ask whether the consumers of Islamic finance products are reasonably protected from financial market manipulation. The Goldman Sachs Sukuk debut has set off a furor of controversy among Sharī'ah, legal and financial experts. The Sharī'ah compliance of the structure relates, to a large extent, to the value proposition of Islamic financial intermediation. Regardless of the legal tantrums the proponents and antagonists of the structure have thrown at each other in the media sphere, I'd like to make a few comments regarding the governing law of the GS Sukuk.

According to the GS Base Prospectus, the governing law of the Sukuk issuance depends on the issue at hand. If the dispute relates to the enforcement of any obligations of the parties, the subject matter of the dispute will be decided under the laws of England and Wales. However, if it relates to Guarantee, it will be decided under the laws of the State of New York, USA. According to the Base Prospectus, "In such circumstances, the judge may first apply the relevant law rather than *Shari'* principles in determining the obligations of the parties." This implies that no reference will be made to Sharī'ah principles while deciding the obligations of the parties. This fundamental element does not make the whole transaction Sharī'ah compliant. An alternative provision should have been the use of expert opinions while the forum may remain the English court while Sharī'ah remains the governing law. After all, matters relating to foreign law in English courts are treated as question of facts, which can easily be proved by Sharī'ah experts (Fentiman, 1998; Hausmann, 2008). Every Islamic finance transaction is a continuum of activities from the contract stage to the post-execution stage where parties are strictly required to comply with the Sharī'ah (Foster, 2006). Any break in the continuum of activities that deviates from the Sharī'ah rules may be cancerous to other parts of the continuum. We have witnessed such in some earlier cases such as the Beximco case, etc. (Oseni & Hassan, 2011). This growing challenge remains in most Islamic finance contracts and the stakeholders pretend all is well. Even though AAOIFI has blazed the trail to set a new direction for the industry few years ago with the release of its Arbitration Standard, many Islamic financial institutions still find it difficult to incorporate an Arbitration Agreement in their Islamic finance contracts even though this is now the practice in developed societies (Oseni, 2011). But for whatever reason, it seems English law is more favorable to Islamic finance contracts concluded in GCC countries.

Value Proposition in Islamic Finance Industry: Legal and Regulatory Reforms:

This section provides some insights into the immediate legal and regulatory reforms required to reposition the industry toward the value proposition on Islamic financial intermediation.

A. Experts of 'Law of Islamic Finance' to work with Sharī'ah Scholars:

There is a need for formal specialization in the regulation of Islamic finance. Foster has continuously advocated for a new specialist area of Islamic finance to be known as "Law of Islamic Finance" (Foster, 2007). Though the experts in this proposed field might not necessarily be Sharī'ah scholars, they will be well equipped with the in-depth knowledge and expertise of Islamic finance generally with special reference to the regulation of Islamic finance in different jurisdictions across the world. This group of experts should be able to complement the functions of the Sharī'ah Boards, and if need be, they may be appointed as members of such boards, to proffer the much-needed guidance to the board on the specifics of regulation of Islamic finance products /institutions in that particular jurisdiction. The need for this group of experts is explained thus:

The legal aspects of Islamic finance have not yet been considered to constitute an independent subject. However, with the growth in the importance, maturity, and complexity of the field, and as more and more lawyers specialise in the area, that approach is starting to look out-dated. The time has come for a conscious recognition that the phenomena described above are more than a set of disparate events, that they are the beginnings of a system. The time has also come for an acknowledgement that a new area of legal studies has emerged: Islamic Finance Law (Foster, 2007: 188).

Recent experience has shown the proclivity for hard work on the part of the Sharī'ah scholars but they only issue their rulings on what is brought before them by financial experts. The experts in the 'Law of Islamic Finance' will be able to go extra mile to consider, for example, a new product in the light of the applicable legislation in such jurisdiction. These experts will be able to guide the Sharī'ah scholars on the nature of the laws of such a jurisdiction and the Sharī'ah compliance of the new product when transacted under such laws. Though some may want to discountenance this idea as being superficial, in the long run, it may help prevent instances of sukuk default and bankruptcy of Islamic finance institutions. The menace of sukuk default and bankruptcy in the industry has been partly blamed on the new trends of 'forum shopping' for Islamic finance products particularly sukuk, and 'fatwa-shopping' among Sharī'ah scholars. These growing trends of "forum shopping" for 'liberal' jurisdictions to issue Sukuk and the vicious tactic of "fatwa shopping" among scholars have negatively impacted the value proposition of Islamic finance.

B. Regulatory Challenges:

There is an absence of supportive regulatory framework in most jurisdictions particularly in the West and this has resulted in different practices in the industry. The weakness of the regulation in some countries has unfortunately created an opportunity for some Islamic finance institutions to go haywire with special reference to the prudential management of clients' funds (Agha, 2012). This challenge can be addressed through professional rules of conduct among Islamic finance practitioners. Each country should have its own unique professional body for Islamic finance professionals under which all the Islamic financial institutions operating in such jurisdiction should register. Without overlapping with the duties of the Sharī'ah Board, this body should only be saddled with the responsibility of maintaining discipline and professional conduct and may also be empowered to carry out periodic Sharī'ah audit.

The above recommendation is meant to enhance the value proposition of Islamic finance as a global industry. Necessary measures to protect the consumers of Islamic finance products must be put in place in line with *maqāsid al-sharī'ah*. Such reforms may not be easily achieved through the existing legislative provisions. So, private initiative within the Islamic finance industry may be necessary as explained above. When such an Islamic finance professional body, which may be a Chartered Institute of Islamic Finance Professionals, is established, it must be empowered under the Memorandum of Understanding among the Islamic financial institutions in such jurisdiction to discipline any erring individual or institutional member.

C. Social Entrepreneurship:

The understanding of 'Financial intermediation' from the Islamic finance perspective requires a holistic approach, which does not allow for financial exclusion for whatever reason. High risks, high costs and lack of enforcement has subtly excluded the lower-income consumers and SMEs from the value proposition of Islamic finance. The Islamic financial institutions should be mandated to undertake and sponsor social entrepreneurship projects to cater for the SMEs and lower-income consumers to be socially responsible. Islamic finance should be at the forefront in finding entrepreneurial solutions to pressing social problems in order to reposition itself as a panacea to the economic woes of the conventional finance in the global economy (Oseni & Hassan, 2010). It is not enough to continue to recount the progress achieved in the Islamic finance industry in figures without practically seeing the impact of the rapidly expanding industry in Muslim communities across the world (McNamara, 2012). One may be tempted to ask whether the Islamic finance products are only for the rich? (Khan, 2012). Some analysts believe the Islamic finance industry has not pragmatically addressed this concern. For instance, Asutay (2007: 179) argues:

Pertaining to fulfilling aspirations, IBF [Islamic Banking & Finance] has not positively affected social capacity building and contributed to widening ownership. Widening ownership could have been possible through venture capital or profit-loss sharing type of investments. However, as discussed previously, these do not seem to be preferred by IBF. It would seem that the characteristics of IBF do not reflect the Qur'anic economic meaning of authenticity or Sharī'ah based principles as located in the aspirational notions of Islamic economics.

The aspirational notions of Islamic economic principles emphasize on social entrepreneurship with an emphatic provision for the less privileged. Social entrepreneurship goes beyond microfinance because some Islamic finance institutions may claim they carry out microfinance programs to assist the poor. The Islamic finance industry should leverage the available resources in enhancing the original value proposition of *fiqh al-mu'āmalāt* by improving the socio-economic lives of the people through social venture that would benefit both the people and the society at large. This will tremendously improve the quality of lives of the consumers while empowering them financially to be independent.

D. Global Integration:

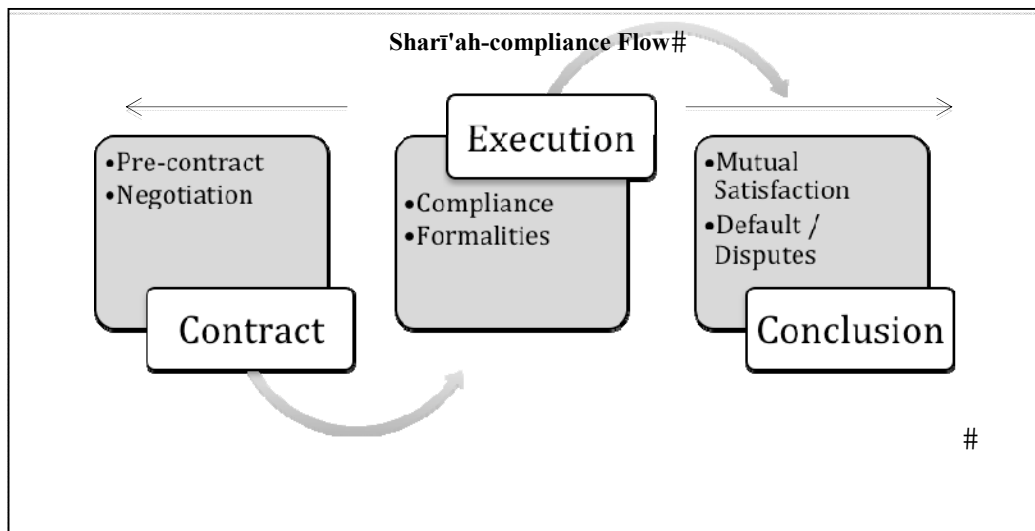
Traditionally, Islamic law does not reject foreign values as long as they do not contradict the fundamentals of Islam. Once such foreign rules or principles are in consonance with the *maqāsid al-sharī'ah*, they are thereby classified as part of *maslahah mursalah* (unregulated public interest) – a secondary source of Sharī'ah. The implication of such foreign rules is that they are taken into consideration as if they originally emerged from the fundamentals of Sharī'ah. Thus, in accordance with this line of reasoning and the need to further expand the market base of the Islamic finance industry, there is a need for an in-depth study of most practices and rules of conventional banking with a view of coming up with better rules that are ordinarily Sharī'ah-based though inspired by conventional practices. This progressive approach to product development has been used in some jurisdictions such as Malaysia. Islamic law consists of timeless wisdom, which can regulate the affairs of mankind regardless of the time and space; hence, the need to ensure global integration through competitive products which are not only Sharī'ah-compliant but conventionally viable. This was emphasized by Zeti Akhtar Aziz, Governor, Bank Negara Malaysia during a forum:

Islamic finance is now at the threshold of a new era in which it will potentially play an increased role in strengthening international financial linkages between nations. Islamic finance has the potential to contribute to the efficient mobilization and allocation of funds across regions. IF [Islamic finance] not only has a potential role in strengthening integration and linkages within Asia but also more importantly in forging linkages with other dynamic emerging regions such as the Middle East(Akhtar, et al., 2008).

Playing such a role is in harmony with the original objective of Islamic commercial law, which encourages trans-national trade and economic linkages insofar as such attitudes benefit the people. Hence, the Islamic finance industry cannot afford to remain in a comfort zone. It must come up with products that are readily acceptable and tradable even in Western countries.

E. An All-Embracing Sharī'ah-Compliance:

Though the importance of integration of the Islamic finance industry into the global financial system has been discussed, it goes without saying that the processes should necessarily be Sharī'ah-compliant. An all-embracing model is required in the compliance trajectory of the Islamic finance industry beginning with the pre-contract phase up to the post-contract phase. In any Islamic finance contract, the whole process starts with product development, which results in an Islamic finance instrument ratified by the Sharī'ah Supervisory Board of the Islamic financial institution (IFI). Such instrument is thereafter marketed to the general public as a Sharī'ah-compliant product. The phase of marketing itself must also be Sharī'ah-compliant(Alserhan, 2011). These pre-contract procedures culminate into the negotiation phase of the contract between the customer and the IFI. At the execution phase, all forms, contracts and processes must not contain any non-Sharī'ah compliance element, as this is considered as the most crucial stage where the Islamic financial transaction practically takes place. Finally, once the parties are satisfied with the transaction, i.e. the product or services, then the contract naturally ends. However, there are situations where there is a default from either party. In such situations, a dispute naturally arises. Managing such disputes is also crucial because it creates the basis for future transactions. Such post-contract issues, as a matter of fact, should be Sharī'ah-compliant. This may involve either debt-restructuring in the case of debt-based Islamic finance transactions. What is generally required in the Sharī'ah contract flow as shown in Figure 1 is that the element of Sharī'ah compliance should not be restricted to the pre-contract stage where the certification of the Sharī'ah Supervisory Board is needed.



Source: Author

Fig. 1: The Sharī'ah Contract Process Flow.

In its 2008 pronouncement, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) advised the Sharī'ah Supervisory Boards to be proactive in their duties, and not to limit their roles to the issuance of Sharī'ah resolution on issues brought before them:

Sharī'ah Supervisory Boards should not limit their role to the issuance of fatwa on the permissibility of the structure of Sukuk. All relevant contracts and documents related to the actual transaction must be carefully reviewed {by them}, and then they should oversee the actual means of implementation, and then make sure that the operation complies, at every stage, with Shari'ah guidelines and requirements as specified in the Shari'ah Standards(AAOIFI, 2008).

In fact, there should be a Sharī'ah Compliance Officer working very closely with the Sharī'ah Supervisory Board who is saddled with the responsibility of monitoring the level of compliance in the execution of every Islamic finance contract to avoid incidences of either non-compliance or inaccurate compliance with the Sharī'ah resolution.

Professionalization of Islamic Finance Practice:

While the rapid increase in the practice of Islamic finance across the world is unprecedented considering the short history of this hitherto niche sector of the global economy, there is the fear of proliferation of half-baked experts churned out from some unaccredited institutions or programs. This calls for the professionalization of Islamic finance practice just like the legal and accounting profession respectively. This proposition may be championed at the AAOIFI level. All institutional members of AAOIFI may agree under a Memorandum of Understanding that they will only engage the services of accredited practitioners, ranging from legal, finance, accounting or auditing experts in all their transactions. For instance, the Islamic finance industry may borrow a leaf from the practice of the Chartered Institute of Arbitrators, which had massively over the years spread its tentacles across the world. Having a similar model backed with local legislations regulating the practice of Islamic finance would go a long way in ensuring quality control in the Islamic finance industry.

Conclusion:

The fundamental basis of Islamic financial intermediation is summarized in the broader objectives of Sharī'ah. Such objective is required to fulfill the needs of the larger society while maintaining its ethical values. With the crystallization of Sharī'ah-compliant financing, there is the need to now focus on sustainability and innovation through the adoption of acceptable best practices within the global financial system. This does not foreclose the possibility of innovating Sharī'ah-base products that are commercially viable and conventionally acceptable. One cannot boldly conclude that the Islamic finance industry escaped the 2008-2009 global financial crises unscathed. But, as Warde (2012: 27) argues, "the Islamic sector weathered the financial meltdown better than the conventional sector." There is no doubt that there are challenges in the industry such as high debt levels, poverty in Muslim societies despite the prevalence of IFIs, concentration of wealth in the hands of the few, insolvencies, etc. These challenges make it imperative for the stakeholders to revisit salient issues underpinning the original value proposition of Islamic financial intermediation.

For Islamic Finance to achieve its original value proposition, it has to merge the processes of Sharī'ah-compliance with social responsibility, and above all, it must be conventionally viable. It is my hope that the above suggestions will spur new ideas and new ways of enabling those ideas to translate them to better policies in reenacting the original value proposition of Islamic financial intermediation in the modern practice of Islamic finance. We need to rekindle the value proposition of Islamic finance intermediation particularly in countries where Islamic finance products are just gaining grounds. Countries in Europe, North America and Africa need to be convinced about the value proposition of Islamic finance as practiced today.

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