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JOURNAL OF MANAGEMENT

The Salient Characteristics of Islamic Finance and Banking Law

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Abstract

Islamic finance and banking have been burgeoned throughout the world and many countries want to have a stake in it. Islamic banks connote to prohibition of payment or receipt of pre-determined interest rate. Payment or receipt of pre-determined interest rate is regarded as usury (*riba*). The Islamic system substitutes pre-determined interest rate by the principle of profit-loss sharing, which aim to transform the banks into equity-based firms. The principle of profit-loss sharing seems to be a possible cure for instability. This research wants to stress that the payment to depositors of a fixed interest impacts negatively on banks. This inhibits the banks from instantaneously adjusting to the financial crisis. It is obvious that such rigidity can lead to possible financial instability. Debt-financing of the conventional banking system protects only the financier. The real investor (equity holder) has to bear the entire risk of the enterprise. Under Islamic banking and finance both the financier and the investor are subjected to the same risks – this stratagem would promote stability and will accord an element of justice to the Islamic model. The research adumbrates the notion that Islamic interest-free banking systems make provision for immunity against bank failure and financial instability.

Keywords: islamic, finance, banking, interest-free

1. Introduction

In order to extol the inherent values of both the Islamic and conventional finance and banking systems, it behooves the reader to ask: What do we mean by financial stability?

The important criteria are not the number of bank failures *per se*, but the degree to which liquidity and solvency crisis would reverberate beyond the respective individual institutions. This paper serves as an outcry for the questions as to what should be done, or what can be done to ensure stability? The main problem is that financial instability does not always come in small and medium sizes. Sometimes it arrives in large or giant economy-size packages and we cannot be sure that we are always prepared to deal with that. When a bank is finally driven to the wall, it can financially strap a good many of its trusted customers and it can drag a succession of not so strong neighboring financial institutions along with it (Hollard, 1985).

No failure is acceptable. Financial stability comes down to "no failures." In the words of Flannery, "[…] financial stability is equivalent to bank stability" (Flannery 1985).

Bank failures result in unnecessary liquidation costs or disruption in productive technology. It imposes a cost on the economy and disrupting the payment system (James 1985).

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2. A Cursory Overview of the Islamic Economic System *versus* the Conventional Model

In cases, when a loan is not paid timely, bank management imposts a penalty with the resultant effect that a borrower is burdened by paying twice or double the principal amount. Belated payment would exert a penalty tantamount to the principal. These unjustified charges would prove to be an obvious case of usury (Swartz 2010).

The amassing of revenue under a capitalist system will serves as a harbinger for the creation of imbalances in its distribution and the eventual ceasing of circulation of money. The concentration of wealth is an example of capitalism. On the other hand, Islam reverberate an aversion of the accumulation of surplus wealth. On the basis of this contention, it is obvious that the Islamic doctrine presents an antithesis to capitalism. Capitalism connotes heaping up of revenue by affluent individuals. This situation heralds a bleak picture of a national economy (Swartz 2010).

Islam frowns upon the unjust situation where a lender is assured of interest without shoulder any risk with a borrower. Due to interest charges the full payment of loans is rendered impossible. The debtor is forced to incur another loan in order to escape, but the piling-up of interest charges exacerbate his already hopeless financial condition. The endless payments of loans reduce a substantial portion of the debtor's income and they fail as a result thereof to take care of their families (Swartz 2010).

On the strength hereof, the elimination of interest in the Islamic finance and banking system tends to enhance stability. The creditor and debtor are seemingly conjoined and they are obliged to contribute one way or the other in the business venture. It is because of this fair justice or fair play in finance and banking that this ethical principle of Islam evokes respect from Muslim and non-Muslim. Islamic finance and banking system has therefore been invited or is making an indent into an increasing number of conventional financial systems. The result is that this industry has shown phenomenal growth in the finance and banking realm of the world (Solé 2007).

Islamic finance and banking is to be based on the principle of justice with the undertone of risk sharing. The equity element in Islamic finance and banking stems from a religious and ethical basis (Hasan & Dridi, 2010).

3. Research Problem and Finding(s)

The global financial crisis and its negative impact on the finance and banking realm of the capitalist world, has triggered this research. Although Islamic banks have not been directly affected, the research stresses it is necessary to investigate patterns for the avoidance and if a crisis of this magnitude happens again, offshoots how to ward it off, be construed in this study. Risk-sharing, which the conventional or interest-based system lacks, is one of the factors that shielded Islamic institutions from the detrimental effects of the crisis (Hasan & Dridi, 2010).

Case studies of banks in different countries in the sphere of the Islamic and Conventional realm have been conducted to establish the stability and sustainability of these institutions (Darrat, 1988).

This research is mainly a theoretical review and opted for an exploratory study about the performance of the Islamic and Conventional model. Two questions adumbrated in the course of the study are the performance of these banks under crisis situation and the challenges posed by the crisis especially for the Islamic banking and finance model.

The research has found that studies by Darrat (1988) and Khan (1986) have established that the absence of interest-bearing assets have enhanced the stability of Islamic or interest-free finance and banking.

4. Methodology

This paper utilized an exploratory study opted for transactions recorded in Tunisia over a period of time (1960–1984). With the aim of establishing which system seems to be more stable, Darrat (1988)

employed the Fishirian equation of exchange: MV = Y where M is money supply, V is the velocity of money and Y is the aggregate nominal income. This equation explores that an unstable pace is tantamount to financial and economic instability. On the other hand, Darrat (1988) affirms that the behavior of non-interest pace of money (Velocity, Money, Non Interest, VMNI) appears to have been very smooth and stable. The VMNI appears to be almost constant.

According to the research the pace of non-interest-bearing money is much smoother and more stable than that of interest-bearing money.

Darrat also employed for the period 1960–1984 in Tunisia the Chow (1960) and the Farley-Hinich (1970) techniques to test for structural stability. The equations are as follows:

$$\log(\mathrm{MNI/P})t = \underset{(4.32)}{-1.272} + \underset{(5.16)}{0.794}\log \mathrm{Xt} - \underset{(0.16)}{0.061}\,\mathrm{Pe/t}$$

$$+\underset{(1.64)}{0.248}\log(\mathrm{MI/P})t-1$$

$$R2 = 0.98, SE = 0.044, DW = 1.76, h = 0.86, TAU = 12$$

And

$$\log(\mathrm{MI/P})t = \underset{(2.57)}{-2.186} + \underset{(3.38)}{0.518}\log \mathrm{Xt} \underset{(0.83)}{-0.625}\mathrm{Pe/t}$$

$$+\underset{(10.23)}{0.676}\log(\mathrm{MI/P})t-1$$

$$R2 = 0.98, SE = 0.090, DW = 1.99, h = 0.03,$$

$$TAU = 14\,(\text{Darrat } 1988).$$

Darrat concluded by stressing that the results of both tests emphasize that the people's need for non-interest-bearing assets is stable over time, while their demand for interest-bearing assets suffers from instability over time. It is evident therefore that the presence of interest-bearing monetary assets in finance and banking transactions seem to be a problem and perhaps maybe one of the reasons for global financial crisis. On the other hand, non-interest-bearing monetary assets behave well and thus forge notions or claims of stability in the financial and banking sector. The stability of financial assets of the Islamic finance and banking component inclines to evoke the attention of academic and policy makers and aims to steer the finance and banking system to redress and adopt an interest-free approach.

This research proclaims the stability of the Islamic finance and banking sector. The research limitation, is however, confined to Tunisia and Iran. To rely on only two countries, in order to test the hypothesis of the stability of the Islamic sector, is not sufficient. The banking sector of more countries from the Western and the Islamic world must be subjected to do justice to a statement about the stability element of the Islamic finance and banking sector (Abizadeh & McCormick, 1997). A pure theoretical study to buttresses such contention, such as the stability of the Islamic system, requires further empirical verification. This research warns that only a single study done by Darrat (1988) to support the stability notion of the Islamic finance and banking is not enough. Yousefi et al (1997) underpin Darrat's notion that the Islamic model yields stability. Their support for Darrat hinges upon the fact that the Islamic system is under the control of the authority (central bank) and withstands influences of non-policy factors. Khan (1989) concurs with Yousefi et al (1997) that the more effective the methods of monitoring, the more the stability factor of the Islamic finance and banking be established (Khan, 1989).

Yousefi et al (1997) proposed that Iran be also the objective of their analysis in testing for the stability of the Islamic system. The results confirm Darrat's conclusion or notion that the Islamic model is relative stable. The study concludes thus that a case for stability has been made in Tunisia and Iran. The fact that the stability of the Islamic system could be affirmed by both countries is conclusive evidence of its stability or superiority status.

Khan (1990) agrees with Darrat (1988) by establishing the stability of interest-free money (Islamic banks). He (Khan (1990)) singles out Pakistan as his experimental subject. Two time frames (*e.g.* 1959–60 and 1986–87) are postulated, but the periods from 1980–82 will be utilized. Khan (1990) asserts that separate interest-free and interest-based counters be opened in both

commercial banks and Islamic banks. The public responded in favor of the interest-free system. Khan (1990) alludes that the profit and loss sharing system of the interest-free banks serve as an attraction for investors or deposits. Interest-bearing deposits have as a result succumbed to profit and loss sharing deposits of Islamic banks. Khan explores a decline of interest-bearing deposits percentages, while he believes that interest-free deposits are undisturbed. He emphasizes therefore the stability of Islamic finance and banking methods.

This research adumbrates that Khan's (1990) study of how Islamic banks in Malaysia performed in liquidity, profitability and solvency are far from satisfactory. Samadand Hassan (1984; 1987) are of the opinion that issues such as profitability, liquidity, risk and solvency are important to depositors and investors. They also stress the importance of worship and trust or trusteeship. These sentiments deduce them to purport the liquidity and solvent character of Islamic banks and thus established its stability characteristics. The latter scholars also state that interest-free products such as *mudarabah* (trust profit sharing) and *musharakah* (joint venture profit sharing) are likely to increase over the years. *Mudarabah* and *musharakah* are constantly under bank supervision. They explain therefore that the chances of failures in Islamic banks are therefore minimized.

An analysis of empirical results done by Salam & Hassan (1984–1987) claim that low risk of Islamic banks is due to its investment in government securities. Islamic banks have therefore more equity capital compared to assets. They believe that larger equity capital gives rise to a higher shock absorbing capacity of the Islamic bank. By comparing interest-free Islamic banks with interest-bearing conventional banks, Samad & Hasan conclude that Islamic banks are more stable than conventional interested-based banks. This stability factor is engendered by a higher liquidity and a less risky mode of finance and banking. This research claims that cases of stability of Islamic banking and finance have been made by Khan (1990) in Pakistan and by Samad & Hassan (1984–1987) in Malaysia.

5. Stability of Islamic Monetary Instruments under Dual Banking System

Kaleem (2000) criticized Darrat's (1988) Tunisian claim of stability under the Islamic finance and banking system. The former exerts that Darrat's (1988) selection of Tunisia as a model of comparison was ill-considered, because the mentioned country does not have a history of Islamic banking. Darrat's study or hypothesis is therefore implausible. Kaleem (2000) asserts that no study has thus so far made up for dual banking in Malaysia for example. According to the purview of this research Kaleem would have asserted that Samad & Hasan's (1984–1987) study, lack a comparative analysis. For that purpose he suggested such analysis for Malaysia. According to Kaleem, the Malaysian authorities introduced an interest-free banking system in 1993. Under this scheme conventional banks were subjected to tests which would establish their stability character as compared to Islamic banks. These conventional banks were required to open separate Islamic counters in their branches (Kaleem, 2000). The reason for this stratagem was to use control as an indicator of buttresses stability.

Kaleem (2000) alleges that control may attribute to the stability notion of a banking system. The notion that traditional interest-based bank's controllability mechanism is effective is refuted by scholars. The latter argue that a country that practice interest-based transactions cannot have full control over their financial and banking institutions and the latter's instruments. Kaleem buttresses Darrat's (1988) viewpoint and assumes that banks exert more control over Islamic financial instruments. Islamic banks are therefore subject to more controllability, which thus vouch for their effectiveness. On the strength hereof, Kaleem concludes that Islamic finance and banking manifest their strength under dual banking in Malaysia.

6. Profit-loss Sharing

Islamic banks utilize profit-sharing and loss-bearing investment accounts. Funds are invested in asset portfolios through investment account holders. The

profit-loss sharing instrument is a mechanism whereby Islamic banks are subjected to regulation by the government or central banks. This will enable the Islamic finance and banking sector to sustain stability (Archer & Karim, 2006). Under profit-loss sharing, banks and investors shoulders risk according to predefined rules (Khan 1986). These rules are based on the concept of *mudaraba*, which refers to transactions, for example, under which profits and losses are also shared by the borrower and lender in some mutually agreed proportions.

Under the profit-loss sharing the depositor is denouncing a settled return on his money deposit by the bank. The depositor would rather be treated as if he is a shareholder. In case of loss, the depositor will share that. In the case of loans, profit-loss arrangement is supported in this study (Khan 1986). Examples of these arrangements are *Shari'ah*-compliant contracts, such as *murabaha, musharaka, ijara, salam, istisna'e* (Archer et al. 2006).

Investment under a *mudaraba* contract raises governance issues. Investment account holders (IAH) are entitled to receive their payment or investment at maturity. Archer et al. (2006) assert that Islamic banks are not obliged to pay investment account holders until the results of the investments funds are determined. If Islamic banks are too impetuous and engage in payment, they can be subjected to reputation risk. The result is that investment account holders will be deterred to invest in Islamic banks. In order to counter this situation, Islamic banks make provision for losses of investment account holders' investments (Archer et al. 2006).

Khan (1990) echoes the notions of for example, Naqvi (1982) and Khan (1984) who aver that profit-loss sharing system is relatively recent and it is not possible to state with confidence that such a system will function better than the interest-based system. In contradistinction with the former authors, Khan mentioned there are other authors who argue that the Islamic interest-free model can function better than the interest-bearing system. This notion is endorsed by analysis already furnished to the effect in this study.

A theoretical approach follows. Khan (1986) cited Simons (1948), a proponent for an interest-free system, who arguing in the context of bank collapses in the 1930's that the interest-based system was "inherently unstable." In connection with bank failures in the United States during the 1980's, there has been a revival of proposals for an interest-free system (Khan 1986).

Khan (1986) cited papers by Kindleberger (1985), Kareken (1985), and Golembe and Mingo (1985) presented at a conference organized by the Federal Reserve Bank of San Francisco, which stresses the potential financial instability of interest-based transactions.

7. Peculiar Risks of Islamic and Conventional Banks

The underlying financial principles of an interest-free model, is a risk to be shared amongst participants (McKenzie 2008). The global financial crisis has provided a valuable opportunity for Islamic finance to demonstrate the usefulness of its chief characteristics – risk sharing. Interest-free finance activities through risk sharing are rooted in the *Qur'an*, verse 275. According to this verse, all economic and financial transactions are conducted *via* exchange contracts (*al-Bay'*) and not through interest-based debt contracts (The Review. Islamic Finance and Risk Sharing: 3).

Islamic Banks vary in terms of the level of risk sharing. On the deposit side (*Murabahah* transactions), deposits do not have risk sharing features, since their return is guaranteed. On the asset side, risk sharing (*Mudharabah* and *Musharakah*) credit risk is regarded as the main risk faced by Islamic Banks. Islamic Banks also involve market risks. And because of its activities, Islamic Banks create liquidity, operational, strategic and other types of risks. Liquidity risks are however a challenge for Islamic Banks, because of the rudimentary stage of this structure. Liquidity risk engenders limitation on bank deposits and the absence of inter-bank rates except under *Murabahah*. This limitation has the effect that if deposits are growing, they can be a source of systemic risk. On the strength of this observation, it is practical that Islamic banks are to be

subjected to similar regulatory and supervisory regimes as Conventional Banks (Hasan & Dridi, 2010).

It is also asserted that trade and financial integration increase interaction resulting in greater familiarity which facilitates risk-sharing. Failure of interest-based banking during the financial crisis has lacked a degree of risk sharing. Conventional contracts employed opportunities and instruments of "risk shifting" rather than risk sharing. The slow progress of conventional finance to promote risk-sharing has provided Islamic banking and finance with a valuable opportunity to demonstrate its usefulness on a global scale (Hasan & Dridi, 2010).

A risk sharing system would be stable and capable of generating employment, income and growth. Islamic finance would reduce poverty and induce growth through risk sharing. Risk sharing would facilitate consumption smoothing for those experiencing liquidity shocks (Hasan & Dridi, 2010).

8. Shocks–reasons for the Possible Instability of Interest-based Banking System

Khan (1986) affirms the stability of an interest-free banking over that of an interest-based one. This research does not try to imply that the interest-free system is always more stable, or that the traditional or interest-based system is necessarily unstable. It only suggests that there may be situations in which an Islamic financial system can adjust relatively faster to shocks than would the traditional interest-based system (Khan 1986). In order to absorb shock, interest-free Islamic banking employs its profit and loss sharing paradigm, which is based on (as mentioned earlier in the research) *mudaraba* (profit-sharing) and *musharaka* (joint venture). Chong and Liu (2005) assert that under the profit loss sharing system, the assets and liabilities of interest-free banks are integrated in the sense that borrowers share profits and losses with the banks. They therefore argue that interest-free banks are the oretically better poised than conventional interest-based banks to absorb external shocks.

Khan (1986) citing Simons (1948), states that the basic flaw in the traditional interest-based system is that, as a crisis developed and earnings fell, banks would seek to contract loans to increase reserves. He alleges that each bank could do so only at the expense of other banks. In the process some banks would become insolvent and be forced to close. Khan (1986) also cited Mayer (1974), who contends that banks tend to switch from techniques of asset management to those of liability management in the face of a crisis. It means that, if banks raise interest rates to attract or retain deposits in problem situations, and if the total stock of deposits is fixed in the short run, the process would clearly be unstable and would eventually lead to bankruptcies.

Khan (1986) alludes, on the one hand, that an interest-free banking system would be stable in the context of real shocks. On the other hand, he says that interest-bearing banks may try to postpone bankruptcy by resorting to liability-management techniques and raising interest rates to bid for deposits. Such actions, which reflect myopic behavior on the part of bankers, can lead to instability and he opines that the interest-based banking system adjust slowly to shock and could easily become unstable. This research demonstrates that the interest-free system proves to be better suited to adjusting to shocks that result in banking crises.

9. Interest-free System against Interest-based System with Regard to Financing

According to Zarqa (1983) interest-free financing redistributes the consequences of uncertainty over all parties to a business. He emphasizes that debt-financing, in contrast, relives the financier from uncertainty by shifting it on to the real investor (equity holder) who then alone bears the entire risk of the enterprise. Further he holds that interest-free financing – by spreading the same risk over more heads, would promote stability. Each party can absorb its modest share of a loss without significantly upsetting its normal activities or defaulting on its obligations, hence no panic reactions are generated among other business units. He concluded by saying that an interest-free system can contribute appreciably

to economic stability, while an interest-based system predisposes the economy to instability.

We will apply his notion to the Illinois crisis of the bank failures of 1930 and 1980. Kindleberger (1985) says that the general cause of bank failures in the 1930s was the decline in prices, which led to debt deflation. Falling prices of second-grade bonds, mortgages and securities provoked the "first banking crisis" in 1930. This caused a sharp rise of interest rates after 1979 which led to forced mergers and failures. Increases in interest rates knock down prices of long-term fixed obligations such as bonds and mortgages. It also necessitates banks to liquidate assets, possibly at a loss, or to buy funds in the market with certificates of deposit at higher rates. This actuates a run on the liquidation of a bank certificate of deposits when the holders of these liabilities become worried about the bank's solvency. Kindle Berger concluded by saying that the sharpness of the rise of interest rates in 1979 in the effort to halt inflation started a process of bank loss that produced the troubles of 1982, 1983 and 1984 and 2007.

10. Profitability of Interest-free Banking

By becoming shareholders of firms, Interest-free banks elicited a growing interest (Hassan & Bashir 2006). The popularity that Islamic banks gain adds to their profitability according to Hassan and Bashir. These scholars warn that Islamic banks are exposed to a variety of risks. These risks require a looking at aspects of bank operations. In order to establish the profitability of interest-free banks, Hassan & Bashir (2006) proffered a diagram in their work (Determination of Islamic Banking Profitability) to the effect. In their comparative approach between Interest-free and conventional interest-based banking, they have monitored quality indicators. They deduce that conventional interest-based banks tend to have more loan loss reserve than interest-free banks. They also mention an inclination to an aversion of credit risk and preference to lower loan loss provision ratio. In their line of thought they believe that interest-free banks have better asset quality compared to conventional interest-based banks.'

Further, with regard to capital adequacy ratios, they hold that interest-free banks tend to maintain much higher capital-asset ratios than their conventional peers, which outstripped the former with regard to liquidity value. Also they state that liquidity houses certain problems, which allude or connote to insolvency and the subsequent closure of banks. Interest-based banks have a more liquid capacity as regard to Islamic banks and thus are more susceptible to crisis. They concluded by saying that non-interest income reduce the risk of insolvency. Engaging in non-loan activities will engender a soaring on non-interest income over time. It is also contended that the Islamic instrument, *qard hasan*, enable prompt supervisory action, which have a positive impact on the profitability of Islamic banks.

11. Challenges for Interest-free Finance

Despite the fact that most involved in interest-free finance claim the immunity of this sector against the financial crisis, the sources of the current crisis is of the notion that interest-free finance can potentially encounter with the similar fate (despite its relative stability).

Interest-free banks are doing business with other banks. Their fair stability has impressed other banks even in non-Muslim countries, particularly those in Europe. But they face challenges. According to Chong & Liu (2005) the profit and loss sharing system subjects interest-free banks to greater market discipline. On the strength hereof, interest-free banks are to make sound and astute decisions based on the credibility of clients. As investment account holders are paid no return on their investment accounts, this would trigger them to withdraw their funds. Such an action would threaten the bank's solvency (Archer et al. 2006).

12. Prospects of Interest-free Banking

Islamic finance and banking instruments are to adhere to integrity and good governance in its system. These two sentiments will attract a good number of potential customers from the western interest-based banks and at the same time counter an exodus of clients who want to leave the banking institution for greener pastures elsewhere.

The research cautions the banking authorities on the Islamic side to engage in western banking methods also, but without compromising its core values, for example, the prohibition of interest and other forms of *haram*. Islamic banks have to cater for non-Muslims as well, if it is to retain its stand in the global finance and banking market.

In the context of globalization, Islamic finance and banking institutions will find themselves operating in foreign countries or western countries, where interest transactions are the order of the day. As the saying goes or protocol dictates that you have the follow the laws of a country in which you are resident, Islamic banks can still forfeit interest on deposits and avail these proceeds to *qard hasan* institutions. This notion entails that the Islamic banks have to operate side by side with its conventional or interest-based counterpart.

13. Conclusion

This paper has enabled the reader to know what the risks are for the interest-free based economic model. With this knowledge to his/her disposal, the reader will be able to control the risks which hindered the Islamic finance model. As a result thereof, monitoring the Islamic model becomes much easier so that guidelines for risk management can be effective. It must though be *Shariah*-compliant, in order for the profit and loss sharing principle, which underlies the Islamic model, to materialize.

Under the profit and loss sharing principle, the interest-free system redistributes the consequences of uncertainty over all parties to a business. Debt-financing of the conventional interest-based system, in contrast, relieves the financier from uncertainty by shifting it on the real investor, who then alone bears the entire risk of the enterprise. By spreading the same risk over more heads, the interest-free economic system would promote stability.

On the strength of its stability, Islamic interest-free banking is in fact less risky in terms of external shocks, liquidity risks and insolvency risks than conventional banks. These characteristics made Islamic banks less vulnerable to risk than conventional banks. Due to its conservative characteristic, Islamic banks have limited access to liquidity, so that it enables investor's stable and competitive returns. On these grounds, investors give a greater incentive to exercise tight oversight over bank management, since they share risks. The crumbling of the US mortgage and the upheaval in the financial markets in Europe and Asia has generated interest among non-Muslim investors to favor Islamic banking. The global credit crisis has given Islamic banking a chance to show its strength.

Acknowledgements

I wish to express my gratitude towards my team for making this publication possible. They are Mr. Odirile Otto Itumeleng, Mrs. Refilwe Segokgo, Dr. Rekha Kumar and Mr. Wankie.

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