

Emerging Islamic Banking: Its Need and Scope in India

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Muslim Started interest free banking under the Islamic law called sharia, and now we all call it Islamic banking. Today that Islamic banking industry showing an average growth rate of 15%-20% annually and comprises around 400 institutions with an asset under management in excess of US \$1 trillion, according to Standard & Poor's Ratings Services the potential market is \$4 trillion worldwide, therefore this can be a tool for enhancing economic development in India. India is prospering, but Indians are not. On an average, there has been one farmer's suicide every 32 minutes since 2002 because of heavy financial burden. Twenty richest Indians earn as much as what 30 crore poorest people are earning, writes Bimal Jalan, the former RBI Governor (RAQEEB, 2012). With these two issues, the growing Islamic banking and Indian economic problem, this paper is going to investigate the growth of Islamic banking worldwide and will try to find out how an Islamic banking can benefit Indian society. The paper will try to answer two questions, why Islamic banking is growing & its present status worldwide, how an Islamic banking is beneficial for India and how it can help India in boosting economic development in order to enhance India's world competitiveness.

Keywords: Islamic Banking & India, RBI, S&P and World Bank

Introduction

Financial institutions like ABN Amro, HSBC, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Nomura Securities and Union Bank of Switzerland now all have in-house Islamic units (Beng, 2004). Islamic banking operations now exist in about 100 countries. In 1960s when the first Islamic bank was established in 1963, in Mit Ghamr, in Egypt but it did not last long. The first bank explicitly based on Shariah principles was established by the Organization of Islamic countries (OIC) in 1974, called Islamic Development Bank (IDB). This bank was primarily engaged in intergovernmental activities for providing funds for development projects running into member countries. Its business model involved fees for financial services and profit sharing financial assistance for projects (Shiyuti, Khairat, Mourtada & Ghani, 2012). The biggest phase of development of Islamic financial institutions occurred in 1980s. In 1985, the High Council of OIC (Organization of Islamic Conference) declared takaful /Islamic insurance as Shariah compliant. The new, wider spectrum of Islamic finance covers not only banking activities but also capital markets, capital formation and other financial instruments and intermediaries. The biggest change in terms of adaptability came in 1991 when the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established to advice on Islamic finance standards all over the world. Later, the development of uniform standards was supported by other organizations such as Islamic Financial Services Board (IFSB) in Malaysia in 2002. Since then, Islamic finance is spreading all

over the world at a tremendous pace from virtual anonymity to becoming a powerful competitive force in the world today (Shiyuti, Khairat, Mourtada & Ghani, 2012)

Literature Review

The Planning commission of India had constituted a high level committee on Financial Sector Reforms (CFSR) under the chairmanship of Dr. Raghuram Rajan in 2007 which submitted its final report on 12th September 2008 to the Hon. Prime Minister of India (Raqeeb, 2010). One of the important recommendations under financial infrastructure for inclusion by the CFSR was regarding the interest free banking in India as mentioned below. -

"Another area that falls broadly in the ambit of financial infrastructure for inclusion is the provision of interest-free banking. Certain faiths prohibit the use of financial instruments that pay interest (KUMAR, 2012). The non-availability of interest-free banking products (where the return to the investor is tied to the bearing of risk, in accordance with the principles of that faith) results in some Indians, including those in the economically disadvantaged strata of society, not being able to access banking products and services due to reasons of faith. This non-availability also denies India access to substantial sources of saving from other countries in the region.

While interest-free banking is provided in a limited manner through NBFCs and cooperatives, the Committee recommends that measures be taken to permit the delivery of interest-free finance on a larger scale, including through the banking system.

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This is in consonance with the objectives of inclusion and growth through innovation (RAQEEB, 2009). The Committee believes that it would be possible, through appropriate measures, to create a framework for such products without any adverse systemic risk impact” (Chapter 3: Broadening Access to Finance, Page: 35)

“With the present set Banking Regulation Act, Islamic banking just cannot take place as many of the banking principles in place are based on interest payments. However, Islamic banking is possible through a separate legislation,” Mr. Subbarao. Last year during a visit to Indonesia Prime Minister Manmohan Singh also said that he would ask RBI to take a look at the demand for establishing Islamic banking in India. Therefore we can expect the first full fledged Islamic bank in India soon. With this expectation this paper would try to find the people awareness and acceptance of Islamic banking services if start in coming future.

The RBI, in 2005, set up a committee to study the feasibility of introducing Islamic banking in the country. The committee said that it was not possible to introduce the system with the existing rules and regulations. The latest move comes after the Ministry of Finance asked the Central bank to reconsider the possibility of introducing Islamic banking, which is attracting even Western and European countries. The RBI move has generated hope among those pushing for interest-free banking to tap the huge potential of capital flow into the country. Although it is difficult to quantify the amount which could come into India through Islamic banking, officials estimate that it could be in the range of US\$500 billion over a five-year period, should the scheme get implemented with vigour. (RAQEEB, 2009)

Research Problem

“In India thousands of crores earn in interest is kept in suspended accounts, as believers do not claim it. The assets controlled by Muslims are estimated to 1.5 trillion dollars and growing at 15% a year. In Kerala alone it is reported that this money could be above 40,000 crores. Research reveals that a handsome bulk of money in India own by the believers is laying idle which if invested in profit sharing basis, and utilized properly can have a major impact on the Indian economy.” (According to a report published in RBI legal news and views Journal 2005 / Vol. 10 - Issue No.2) (sabakka) .The the amount of population of Muslim is a ready market for the Islamic banking in India and there is a desperate need for boosting entrepreneurship for which we need more financial services of various types and nature. To enhance and facilitates more and more entrepreneurs we need innovative financial services, so with these questions this paper will try to highlights the role of Islamic banking ,what we can achieve with Islamic banking

Objective of the Study

- To understand the concept of Islamic banking
- To highlight the present status of Islamic banking in

India and worldwide

- To Identify Islamic banking need and scope, its future potential in India.
- To identify the size of market for Islamic banking products and services.
- To find the ability of Islamic banking services for boosting entrepreneurship in India.

Research Methodology

The research is basically based on secondary data, secondary data have been collected from the various web sites, and different journals, annual reports, periodicals magazines and weeklies published by the various research companies, Islamic Institutes & colleges and consultancies, various Islamic banks reports and also the analyst organizations.

Origin

We can trace the birth of modern Islamic banking from the days of Prophet Mohammad (peace be upon him) when he used to work as agent in his wife's own business operation. Mudarabah (Islamic partnerships) was one of the oldest forms of business and dominated the business community since centuries and the existence of interest based transaction was very limited in every days transactions. Islamic partnership i.e. Mudarabah performed various economic function. They basically include the three very important factors of production basically labour, capital and entrepreneurship. Labour and entrepreneurship is basically comes under one person, therefore capital owner invest his money and the partners run and manages the business. Profit and loss is shared as per the pre-decided rates. In case of failure of business the investor will loss his capital and the manager who was managing the business will loss his time and labour.

Understanding Islamic Banking

Western bankers have said many times before the global crisis that savings and investments would soon dry up if interest were not paid. But this is due to identifying "rate of interest" and "rate of return". The Qur'an says: "God has permitted trade, but forbidden riba (interest)" (2:275). Therefore it is only the fixed, or predetermined, return on savings or transactions that is forbidden, not an uncertain rate of return, such as the making of profit. Islamic Banking is based on Shariah the Islamic code of conduct, and also an Arabic term that often is translated to "Islamic law." shariah provides guidelines for aspects of Muslim life, including religion, politics, economics, banking, business, and law. Shariah-compliant financing (SCF) constitutes financial practices that conform to Islamic law. IMF indicated that Islamic banking appears to be a complement to conventional banks, rather than a substitute (Ilias, 2010). The three Major principles of shariah that are applicable to finance and that differ from conventional finance are:

- Ban on interest (Riba)
- Risk-sharing and profit-sharing
- Ethical investments that enhance society

Investments in industries which are prohibited by the holy *Quran* such as alcohol, pornography, gambling, and pork based products, is discouraged.

Some Prevailing Islamic Modes of Finance

Mudarabah

An Islamic contract in which one side provides capital and other side provides labour. The profits are to be shared in proportions agreed upon before implementation of the contract. Providers of the capital bear all net loss according to the contract unless there has been violation of the contract terms or neglect from the part of the working partner.

Musharakah

Partnership or more than one party subscribe to the capital of a business undertaking and share profits and losses according to their respective share.

Istisna

A contractual arrangement whereby one party (purchaser) orders a specially defined product to be produced for him by the other party (seller) in the future against the specific price. raw material to be supplied by the producer.

Ijarah

The meaning of ijarah includes lease, wage and rent. This basically includes the selling of use and service against a fixed price or wage. Therefore under this, customer can get the right to use the service of assets and equipments for example heavy machinery, plant, motor vehicle, etc. for the fixed price and tenure.

Qard Hassan

Qard hasan is a kind of loan on the basis of goodwill and the debtor is not charged by interest, debtors only have to repay the borrowed amount, but if the borrower, at his own will wants to pay some interest or some amount additional to the borrowed amount, he can pay to the creditor as thanks giving. Therefore there is no fixed interest rate and this kind of transaction is truly free of interest. It is called interest free loan..

Murabahab

Murabahab is the most popular form of Islamic financing techniques used by the Islamic financial institutions in many non Muslim countries like Australia, USA. Within a murabahah contract, the financial institution agrees to fund the purchase of a given asset or goods from a third party at the request of its client, and then re-sell the assets or goods to its client with a mark-up profit. The client purchases the goods

either against immediate payment or for a deferred payment. (IFLR, 2005)

Salam

Salam is very useful in reducing agricultural sector poverty easily, by enabling the banks and farmers to contract with each other of the crops and to get finance at appropriate time, instead of usurious loans, which ultimately deteriorate through compounding of interest and farmer, will not pay it easily. (Saleem, 2008)

Present Status Worldwide

Industry forecast suggest Islamic banking assets with commercial banks globally, will reach \$1.1 trillion in 2012 (2010: \$826bn). The international field of Islamic finance has been growing at an estimated rate of 15% a year. This growth is occurring not only in the Middle East but also in the Western world and in the developing nations of South Asia and Africa. There are now several Islamic financial institutions operating in the UK, Europe, and the USA. Shariah-compliant assets reached about \$400 billion throughout the world in 2009, according to Standard & Poor's Ratings Services, and the potential market is \$4 trillion. Iran, Saudi Arabia and Malaysia have the biggest sharia-compliant assets.



Islamic banking is not restricted to Islamic institutions purely. In 1996, Citicorp set up CitiIslamic Investment Bank in Bahrain. Following this precedent, financial institutions ABN Amro, HSBC, American Express, ANZ Grindlays Bank, Chase Manhattan, Deutsche Bank, Nomura Securities and Union Bank of Switzerland now all have in-house Islamic units. Islamic banking operations now exist in about 100 countries, according to Gohar Bilal, a former visiting scholar at the Islamic Legal Studies program of Harvard Law School. In fact, there are currently more than 300 Islamic financial institutions spread over 51 countries, plus well over 250 mutual funds that comply with Islamic principles. Moreover, over the past decade, the Islamic banking industry has

experienced growth rates of 10-15 percent per year—a trend that is expected to continue (Solé, 2007). Another source, as per estimates, nearly \$1 trillion is currently being managed by about 400-odd Islamic banks worldwide.

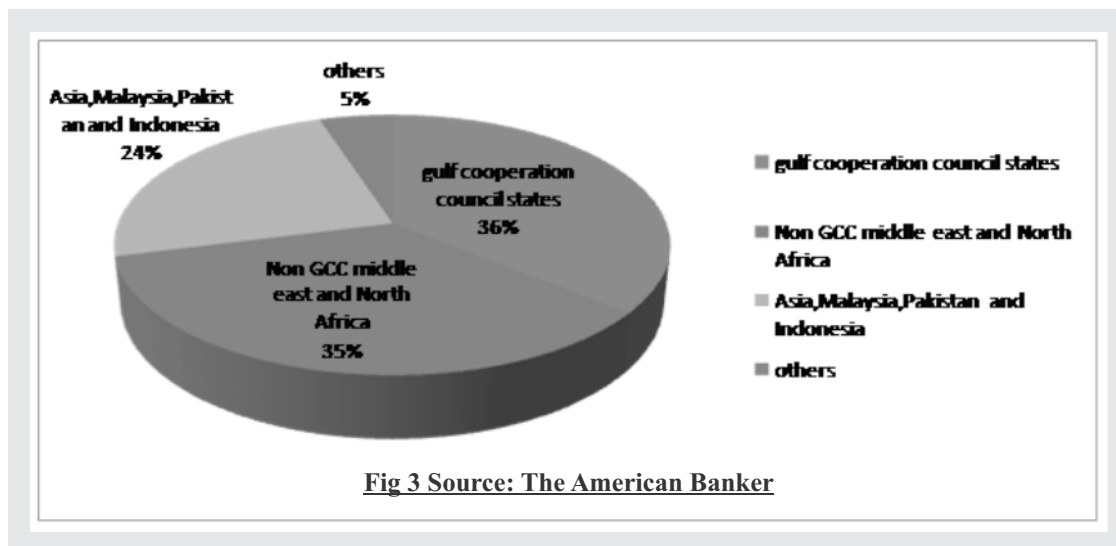
Middle East and North African countries (MENA)

Islamic finance in the Middle East and North African (MENA) countries has now become an important element in their society's development agendas and it is also gaining ground in the financial landscape of the region as well as in the individual countries. It is also a growing business as it caters to the financial needs of the people without conflicting with their social and religious values (Ali, 2011). Several banks are in race to unveil its new customer offerings for MENA customers, in response to growing interest in and customer demand for Islamic finance in the countries and across the regions.

In a report from Ernst & Young, Islamic banking assets with commercial banks globally would reach \$1.1 trillion in 2012, a jump of 33 per cent from the 2010 level of \$826 billion. In the Middle East and North Africa, Islamic banking assets increased to \$416 billion in 2010, representing a five year compound annual growth rate of 20 per cent compared to less than nine

per cent for conventional banks, Ernst & Young said in a report. "As new geographies open up to Islamic banking, the Mena Islamic banking industry is expected to more than double to \$990 billion by 2015," (John, 2011).

In the backdrop of the fast growing demand for Islamic banking, a group of Islamic financial institutions launched the world's first benchmark for Islamic interbank lending recently as an alternative to LIBOR, or the London Interbank Offered Rate. The LIBOR alternative, known as Islamic Interbank Benchmark Rate, or IIBR, uses the contributed rates of 16 Islamic banks and the Islamic sections of conventional banks to provide a reliable alternative for pricing Islamic instruments to the conventional interest-based benchmarks used for mainstream finance. Standard Chartered Saadiq said it plans to start Islamic banking operations in Nigeria and Oman next year, as it looks to grow its Shariah-compliant business in the Middle East, Africa and Southeast Asia. According to the Dubai Chamber of Commerce and Industry, the collective assets of the eight Islamic banks in the UAE were Dh269 billion at the end of 2010, accounting for around 16.2 per cent of the overall banking assets of Dh1.66 trillion. (John, 2011)



"The market of Islamic finance has reached \$1.3 trillion mark, in which the share of Islamic banking is 77 percent (\$1 trillion), share of Sukuk is 14 percent (\$180 billion), share of Islamic funds 5 percent (\$64 billion) and share of Takaful is 1 percent (\$12 billion) whereas the share of other Islamic financial products like Islamic Leasing, Mudarabah Companies, Islamic Microfinance and Islamic REITs is 3 percent (\$44 billion)." Published in first International Forum of Islamic Banks hosted by Jordan 10/07/2012. (Mughal, 2012)

Islamic Banking Current Status in India

A remarkable step taken recently by the Government of Kerala launched a Shari'ah-compliant financial institution and wished to establish it by 2010 (RAQEEB, 2009) after a study is being done through Ernst & Young to analyze the implication of the Central, State and Municipal taxes for establishing Islamic financial institution with the objective to grow into a full-fledged Global Islamic Bank. This institution will be started with a share capital of Rs.1000 crores and the Kerala State Industries Corporation will have 11% share and remaining 89% from private investors. (RAQEEB, 2009)

But due to a petition filed by Janata Party President Subramaniam Swamy it was delayed. The petitioners contended that the state establishing a bank which will work on the principles of a religion, will violate the principle of secularism enshrined in the Constitution (G Ananthakrishnan, 2011). Later in Feb. 2011 The Kerala High Court dismissed that petition. But the present banking system does not allow a full fledge Islamic bank in India. Therefore with the aim to make it first Indian Islamic bank, they have started it as a NBFC now with the name Al-Baraka. Last year during a visit to Indonesia, the country with the world's largest Muslim population, Prime Minister Manmohan Singh had said that he would ask the RBI to look into the demand for establishing Islamic Banking in India. Another signal, A Turkish bank name Asya is keen to start its Indian operations through a representative office in Mumbai. (Tiwari, 2011) The Bank is waiting only for the government clearance. On the basis of these recent acts soon we can avail Islamic banking services which will not only help the Muslim but the society as a whole.

Therefore we can expect full fledge Islamic bank in India soon, considering this a need is realize to know the people awareness level in India which will not only help in knowing the awareness level among masses but also to know, what perception people have and how Islamic banks can target and place themselves in order to make their niche in the competitive field of banking.

Still India Struggling: Problem of Aam Aadami

Even after forty years of nationalization of the banks, 60 per cent of the people do not have access to formal banking services and only 5.2 per cent of the villages have bank branches. Marginal farmers, petty traders, landless labours, self-employed and unorganized sector enterprise, ethnic minority and women—the Aam Aadmi of the country—continue to form “the financially excluded class”. India is prospering, but Indians are not. Twenty richest Indians earn as much as what 30 crore poorest people are earning, writes Bimal Jalan, the former RBI Governor. While the GDP growth is nearly nine per cent, the Aam Aadmi—representing 860 million marginalized Indians—earns only Rs 20 per day. The system has created two sections in our society: the super rich and the super poor. In this scenario when farmers committed suicides, the father of the Green Revolution, Dr M.S. Swaminathan, suggested that Islamic banking may be a solution to the farmers' suicide crisis in Vidharbha. (RAQEEB, 2012)

Needs of Islamic banking in India

- The population of Muslim is about 154 million that is more than 13.2 % of total population. However, 80% are financially excluded owing to unavailability of interest free banking. Sachar committee claims that Indian Muslims have a share of 7.4% in saving deposits while they get only 4.7% in credit. According to RBI annual report for 2007-08, Indian Muslims annually loose around Rs.63,700 crores which i.e. 27% of their deposits (Vohra, 2008). Therefore this large number of Muslims population needs Islamic banking services India.
- Islamic Banking can contributes towards India's economic growth and serves as a mechanism to overcome the country's liquidity and inflation problem. "India has emerged as the fourth largest economy globally with a high growth rate but still the per capita income of India stood at \$1,527 in 2011, it said."...this is perhaps the most visible challenge ("Economic survey 2012-13;," 2012) Muslim avail just 4% and 0.48% credits from NABARD and SIDBI respectively. Islamic banking can boost entrepreneurship in India through its services of financing. Therefore there is desperate need Islamic banking, which can be a solution for entrepreneurship development.
- Islamic banks are evolving financial and investment instruments that are not only profitable but also ethically motivated. The boom in Islamic banking has several reasons, on one hand the industry is young so the growth is natural on the other hand it depends on credit crises. Volatile interest rates, high bank fees and foreclosure in payment defaults make people unhappy of traditional banking system. Islamic banking will fulfill these needs also.
- Indian economy would benefit from inflow of funds from GCC Countries.
- Islamic financial services can boost the Microfinance at low cost with its customary tool based on shariah.
- Opportunity to promote entrepreneurship by providing finance on the basis of profit and loss and risk sharing.
- Islamic Banking can work as a complementary to Conventional banking. During recent financial crisis Islamic banks are less affected compare to conventional banks.
- Large young population (31.1% is below the age of 15 and 63.6% falls in the 15-64 age bracket) is likely to fuel growth in retail lending. Therefore to boost growth rate Islamic banking can also contribute towards retail lending.
- With the introduction of Islamic banking, the problem related to inadequacy between the labour and capital ratio also can be solved through equity finance, which can be a new revolution in the field of agriculture and unorganized sector. Therefore improved capital labour ration will strength to

unorganized and agriculture workers to compete effectively with the organized formal sector workers. As a consequence the Islamic banking will give the financial empowerment to the majority of Indian workers. (YS Team, 2009).

- With great inclusion of Muslim youths in the financial sector they can contribute in a better way and Islamic banking can help counter terrorism. One of the main reasons of terrorism is poverty and Islamic banking can alleviate the condition.
- More option for getting credit especially for those who think and considered less worthy for financing.
- Islamic bank will also create job opportunity for the student of Islamic finance studies, as well as it can also create new field of studies and course for the upcoming student with for those who want to make career in Islamic banking like traditional conventional banking.

Scope of Islamic banking for India

- Potential to contribute substantially in economic growth
- Potential to boost entrepreneurship in India
- Potential to provide low cost, easily available, capital to small poor entrepreneurs in India
- Potential to compliment conventional banking as well
- Potential to bring FDI in India
- Potential to contribute with their services to accelerate growth of micro small and medium enterprises
- Potential to contribute specially in the growth of weaker section in the society
- Potential of Islamic banking includes loans to businesses ethically, morally and beneficial to the society causing speculative businesses to starve from financial point of view (SALEEM, 2008).
- Potential to contribute in the poverty eradication through SME financing, rural and agricultural growth and their operational expansion .Through Individual and corporate zakat accounts it can help in bringing social equality and social welfare in India.
- Potential to reduce unemployment by providing SME sector loans, provide QARD E HASSAN schemes but taking into consideration all security factors(SALEEM, 2008).
- Potential to provide loans to those who do not have securities at disposal and better credit rating.

(SALEEM, 2008)

- Potential to reduce the rocketing inflation through less artificial money creation and less funding of speculative businesses. (Saleem, 2008)

Conclusion

There is need of Islamic banking and also there is a huge scope of Islamic banking, this shows that future prospect of Islamic banking is good. Islamic banking not only covering the needs of Muslim population but it is fulfilling the need for the development of all the community. Considering the present status, Islamic banking is not possible in India as per the present banking regulation. But with the effort from government and reserve bank of India it is possible. . 'Islamic Banking' should be looked as 'Interest Free Banking' through the broad economic kaleidoscope and not a narrow religious prism. Area which can directly affect the growth and development of Islamic banking in country like India is the role of Government participation and intervention in providing necessary arrangements for legislation and legal framework (Ahmad, 2008). Last but not the least, Islamic banking institution should research in Training and Development of people to make sure that they promote Islamic banking properly.

Scope for further studies

Numbers of Islamic finance institution are there in India but they all fall under the category of NBFC or registered under society act. But with recent information and government working towards making Islamic banking feasible in india.we have tremendous scope of research in the field of Islamic banking in India. On the basis of present study, we can conduct the study about the people awareness, a model of Islamic banking feasibility under the interest based banking, acceptance of Islamic banking product and service. We can expect tremendous opportunity in the field of research and studies in Islamic banking in India.

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