

# *Murabahah* Practices in Islamic Banking of Iran: Challenges and Solutions

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## *Abstract*

*The revolution of Iran played a primary role in establishing Interest-free banking after 1979 in Islamic Republic of Iran. The government passed the law of Interest-free banking in 1983 and in 1984 banks started Islamic banking based on the interest-free law of 1983. The interest free banking system of Islamic Republic of Iran is perceived as an effective tool in achieving of the objectives of Islamic economics. It is difficult to accept that a bank can be run without paying or receiving interest and without the involvement of interest banks will play any role in economic development. There are various modes and principles in Islamic banking like Mudharbah, Musharka, Murabaha, Ijarah etc. Murabaha in practice is ambiguous, translucent and usurious in disguise. This paper is an attempt to study the challenges of Murabaha practices in Interest-free banking of Islamic Republic of Iran and suggesting possible solutions.*

**Key Words:** *Murabahah, usury (Interest), Shari'ah (Islamic Laws), Halal (Permissible), Batil (Not-Permissible)*

## **1. Introduction**

The emergence of Islamic financial institutions within financial and monetary organizations is a brilliant phenomenon across the world. Islamic banks have earned much more attention compared to other institutions in playing a key role in financial transactions. It is looked as a viable alternative system in all parts of the world.<sup>2</sup> It is based on the important principle of the Islamic economic philosophy, the prohibition of usury or Interest. The Holy Qur'an mandates Islamic principles fulfilling the exact *Shari'ah's* requirements which focus on a) justice b) risk-sharing c) physically realized transactions and e) the *halal* (Lawful).

However, some believes that some Islamic products are similar to the products provided by conventional banks and others are different. One among them is "*Murabahah*" which is a challengeable contract. According to an Iranian *Shariah* scholar,<sup>3</sup> there is Interest in the Islamic banks of Iran which is wrapped up in the contracts. It implies that Interest is still in action and the Islamic banking system is as bad as its

<sup>2</sup> SufianFadzlan, Mohamad Akbar Noor Muhammad Noor, 2009, "The determinants of Islamic banks' efficiency changes Empirical evidence from the MENA and Asian banking sectors," 2009, *International Journal of Islamic and Middle Eastern Finance and Management*," Vol. 2 No.2, pp.120-138.

<sup>3</sup> Mohaqqeq Mohammad Javad, 2011, "Do Iranian Banks include Riba?", electronic version of the interview is available in [http:// www.tabnak.ir/fa/news/160645](http://www.tabnak.ir/fa/news/160645).

counterpart, conventional banking system. The Iranian customer fails to repay the debt in the name of *Murabaha* posed the question on the permissibility of *Murabahah* contracts.

## 2. Concept of Murabahah

*Murabahah* is driven from *ribh* which means gain, profit or addition and in English it is often translated as mark up or cost-plus financing. In the *Murabahah*, a seller has to reveal his cost and the contract takes place at an agreed margin of profit<sup>4</sup> has defined *Murabahah* as the sale of anything for the price at which it was purchased by the seller and an addition of fixed sum by way of profit. Thus, the seller should disclose his/her capital involved in the deal or let know the cost to the buyer which is lawful without any controversy among the jurists.

According to Imam Malik (1985),<sup>5</sup> *Murabahah* is conducted and completed by exchanging goods and price including a mutually agreed profit margin. Therefore, it is essential for a valid *Murabahah* that the buyer must know the original price, additional expenses (if any) and the amount of profit. Accordingly, *Murabahah* is a contract of transparency and trustworthiness.

*Murabahah* is a pertinent and appropriate product to be used by the Islamic banks for commodity finance. But *Murabahah* transactions can be used when a client of a bank or financial institution wants to purchase a commodity. To comply with the *Shari'ah*, it is necessary in this contracts, the commodity to be actually purchased and taken into possession, physical or constructive, by the bank plus the risk of the commodity as far as it remains under bank's ownership and possession.<sup>6</sup>

However, Kamal Khir et al., Lokesh Gupta and Bala Shanumugan<sup>7</sup> believe that *Murabahah* refers to a particular kind of sale and has nothing to do with financing in its original sense. The basic ingredient of *Murabahah* is that the seller discloses the actual cost he has incurred in acquiring the commodity, and then adds some profit thereon which may be in a lump sum or based on a percentage. According to Tarek El Diwany<sup>8</sup> *Murabahah* is a form of trust sale since the buyer must trust that the seller is disclosing his true cost and a profit margin may be agreed either on a percentage of cost basis or as a fixed amount. It is important to remember that the amount of profit earned in this transaction is not a reward for the use of the financier's money. This occurrence would cause the *Murabahah* to resemble charging of interest.

As a result, *Murabahah* is a commodity sale contract with deferred payments, to legitimize the sale payment process; it should be based on the *Qur'anic* verse: "But God permitted trade". This verse is interpreted that

<sup>4</sup> Al-Marghinani (1957), "Al-Hidaya," translated into English by Charles Hamilton. Premier Book House, Lahore. p.88)

<sup>5</sup> Imam Malik (1985), *Al-Muwatta*," The First Formulation of Islamic Law, translated into English by M. Rahimuddin. Lahore: Sh. Muhammad Ashraf Publishers, p.345.

<sup>6</sup> Salar, 2008, *Islamic Banking and Finance, Shariah Guidance on Principles and Practices*, First Edition, published by A.S. NOORDEEN. p.51.

<sup>7</sup> Kamal Khir et al. (2008), Lokesh Gupta and BalaShanumugan, *Islamic Banking, a Practical Perspectives*, First Edition, Pearson Malaysia Snd Bhd. p.223.

<sup>8</sup> Tarek El Diwany (2010), *The Problem with Interest*, third edition, published by Kreatoc LTD, p.177.

deferred payment sale can involve some increase in the sale but not the increase in the loan which is interest and forbidden. The increase in deferred payment sale is part of the price of the commodity which can be valued by similarity and that no increase may be charged in the exchange therefore.<sup>9</sup>

## 2.1 Murabahah in Islamic banking

*Murabahah* in Islamic contexts refers to a particular kind of sale and has no resemblance with a transaction of financing. But *Murabahah*, was recently transformed from the sale transaction to a mode of financing in the Profit-Loss Sharing (PLS) system of Islamic banking on a large scale. In it the bank, at the request of client, purchases the goods from a third party against payment. Immediately on the transfer of ownership of the goods the bank sells these goods to the client at cost plus an agreed fixed profit margin. The client then takes physical possession of the goods and undertakes to pay the price to the bank either in installments or in lump sum, at an agreed later date. There many cases where customers of the bank and the seller of the goods are related parties. In many other cases, the customers of the bank purchase the commodities themselves as agents of the bank and then they repurchase the same commodity from the bank for a cost plus profit to be paid at a mutually agreed later date.

There are recently serious reservations to the wide spread use of *Murabahah* as a mode of finance where the bank purchases the commodity only after the customer has agreed basically to purchase it from the bank at a profit (mark-up). It must therefore, be appreciated that under *Murabahah*, a trading transaction is being transformed into a mode of finance just to meet the *Shari'ah* requirements.<sup>10</sup> Tarik M. Yousef claims that Islamic banks work under a disadvantage as the long-term financing with *Mudarabah* or *Musharakah* is far riskier and costlier than the long term or medium-term lending of the conventional banks. It sounds *Murabahah* contracts in Islamic banks is somehow a divergence from the theory of equity-based finance. By examining the *Murabahah* syndrome in Islamic finance through the prism of a systematic analysis of financial structures across the world, Tarik M. Yousef finds that Islamic banks, as niche providers of capital, do not operate much differently from conventional banks. It is interesting to note that *Murabahah* has been under critics by many scholars at various forums<sup>11</sup> in a study about the Iranian Agricultural Bank challenge *Murabahah* contracts as superficial documents which are covered up by the ever problem, the information asymmetry.

<sup>9</sup> Abdul Rahman, 2010), *An Introduction to Islamic Accounting: Theory and Practice*, First Edition, CERT publication SdnBhd, p.344.

<sup>10</sup> Siddiqui, S. H, 2001, "Islamic Banking: True Modes of Financing," *New Horizon*, 109 (May-June), p.321

<sup>11</sup> Kazem&Zamir (2002), "Choice between Debt and Equity Contracts and Asymmetrical Information: Some Empirical Evidence," in Munawar Iqbal and David T. Lieclyn (eds), *Islamic Banking and Finance*, Cheltenham, UK, and Northampton MA, USA, Edward Elgar, pp. 139-154.

## 2.2. Murabahah in Iranian Islamic banks

The Almighty God in Qur'an say "those who devour usury will not stand except as stand one whom the Evil one by his touch hath driven to madness. That is because they say: trade is like usury but Allah permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (the offence) are companions of the fire: they will abide therein forever."<sup>12</sup>

Therefore, according to the new constitution introduced after the 1979 Islamic revolution usury is totally banned from the Iranian banking system.<sup>13</sup> After 1979 Islamic Revolution, there were two different options for the Islamizing of banking services before the Iranian authorities. First, keeping conventional banks but omitting usury and utilizing Islamic financial products and second, establishing new banks under purely Islamic laws. The Iranian authorities chose the second option and the banking system is therefore a transformation of Ex-Revolution commercial banks to purely Islamic grounded banks. Since then the Iranian banks have offered Islamic products over these decades such as *Mudarabah*, *Murabahah*, *Musharikah*, *Ijarah*, *Salam*, *Qard al-Hasanah* and *Jealah*. The activities of Iranian banks involve all types of trading, commodity finance, real estate development and leasing. Thus, the main financial instruments used are among *Murabahah*, *Mudarabah*, *Musharakah*, *Muqaradah*, *Ijarah*, *Salam* and *Istisna*.<sup>14</sup> There are different types of *Murabahah* which applied by the Iranian banks over three decades and the different forms of *Murabahah* have been defined in the Iranian Islamic economic philosophy. According to the Islamic Hi-Council of the Tehran Stock Exchange (TSE) in 2010 and Mousavian, S. Abbas and Mostafa Zehtabian,<sup>15</sup> there are the following *Murabahah* products in the Islamic niche of the Iranian financial market.

## 2.3. Murabahah Security (Sukuk) for Finance

In this model, issuer collects the investors funds, buys the originators' required commodity from a producer (seller) in cash on behalf of the investors, after that sells it to the originator in a higher price and in form of a *Murabahah Bay'* with deferred payment. Originator should undertake for paying the price to the issuer on specific maturity dates. Then issuer gives the originators' payments to the owners of securities through an investment bank. The owners of securities can either wait until the maturity date to obtain marginal return or sell their securities in the secondary market in a lower rate of return.

The primary and secondary markets for these securities are a combination of *Wakalah*, cash selling, *Murabahah Bay'* with deferred payment, and *Bay' Dayn* (discount) contracts in such a manner in which the

<sup>12</sup> Al-Qur'an Chapter 2:276

<sup>13</sup> Beizae, S. Ibrahim, 2007, "Present Situation of Interest in Iran," Hamshahri online, 20<sup>th</sup> January, electronic copy is available in <http://www.hamshahronline.ir,no.42176>. Accessed on 18/11/2017

<sup>14</sup> Salar, (2008), *Islamic Banking and Finance, Shariah Guidance on Principles and Practices*, First Edition, published by A.S. NOORDEEN, p. 51.

<sup>15</sup> Mousavian, S. Abbas and Mostafa Zehtabian, (2009), "Operational Models for Ijarah, Istisna and Murabahah Sukuk from Islamic point of view," Working Paper. pp.129-167.

issuer collects the funds, buys the originators' required commodity on cash and on behalf of the investors, then sells it to the originator in form of *Murabahah* with deferred payment. Under the jurisprudential point of view, there may be no problem with *Wakalah*, cash selling and *Murabahah Bay'* with deferred payment contracts while, there is a dispute on selling securities in the secondary market (discount), from other hand. Most of Iranian jurists believe that secondary market based sells are allowed but few of Non-Iranian jurists have rejected it and believe that it is *Batil*.<sup>16</sup>

#### 2.4 *Murabahah Security (Sukuk) for Liquidity*

In this kind of *Murabahah Sukuk*, the issuer should gather the investors funds, buys one of the originators' tangible asset in cash instead of the investors, then sells it to the originator on a higher price inform of *Murabahah Bay'* with deferred price. Originator should commit for price payment on certain dates, in the second stage issuer transfer the funds which have been collected from the originator to the owners of securities via investment banks. As like as financing *Murabahah* security in this type of *Murabahah* security also owners of securities can either wait until maturity date for fully interest utilization or sell their securities in the secondary market before maturity.

The primary and secondary markets for these securities are the same as *Murabahah Security (Sukuk) for Finance*. Regarding the discount issue, buy and sell in cash and with deferred payment in the primary market which is called *bay'alinah*, shall be of jurisprudential problem and many jurists including Iranian and Non-Iranian believe that it is *Batil* and not permissible.

#### 2.5 *Companies Murabahah Security (Sukuk)*

In this type of *Murabahah*, the issuer of *Murabahah* security (company) on behalf of the investors buys the required commodity of the government, firms, and families in cash from the producers (sellers) after collecting investors' fund, and sells it to the government, firms, and families in form of a *Murabahah Bay'*. The issuer (company) receives the price of the commodity from the debtors (government, firms, and families) on certain maturity dates and pays to the owners of securities in associating with banks. The owners of securities can either wait until maturity date for full return or sell their securities in the secondary market.

To participate in *Murabahah* type of trading, owners of securities transfer their funds to the company and the company engages in trading in form of partnership instead of the investors. Company buys the required commodities of the government, firms, and families or other types of producers in cash and sells it in form of *Murabahah* with deferred payment, then collects the receivables of the owners of securities in certain maturity dates and at the end of the fiscal year, distributes the profit among the owners of securities after deduction *Wakalah* fee. The owners of securities can sell their own portion of the company's assets

<sup>16</sup> Mousavian, S. Abbas and Mostafa Zehtabian, (2009), "Operational Models for Ijarah, Istisna and Murabahah Sukuk from Islamic point of view," pp.129-167.

whenever they decide to do that. Trades of this kind are combinations of *Wakalah*, *Wakalah* purchase, *Wakalah* selling, and asset selling in the secondary market which are permissible.

## 2.6. Mortgage *Murabahah* Security (*Sukuk*)

In mortgage *Murabahah* security, issuer issues *Murabahah* security, collects investors' funds and buys, on behalf of the investors, the originators' (bank or leasing company) mortgage facilities of the *Murabahah Bay'* (installment sales) to the government, firms and families in cash and in a price lower than nominal price, then the originator undertakes to collect the facilities from the debtors (government, firms and families) and give them to the issuer. Issuer also pays the funds received from the originator to the owners of securities via an investment bank. Owners of securities can either wait until maturity date or sell their securities in the secondary market before maturity (*Shari'ah* Board Resolutions of stock exchange organization, 2010), Statements of *Murabah*.

A combination, of *Wakalah* and buy and sell of debt (discount) contracts is the primary and secondary markets of these securities in which investors funds are collected by issuer. Issuer then buys the originators' debts of mortgage facilities in cash on behalf of the investors (owners of securities). Investors can either wait until maturity date or sell these securities in the secondary market (discount). In jurisprudential point of view, buy and sell of debt (discount) is disputable and from the Islamic viewpoint a majority of Iranian jurists believe that it is permissible while most of Non-Iranian jurists believe that it is *Batil*, in contrast.

## 2.7. Practical Framework of *Murabahah* in Iran

In practice, a mixture of *Murabahah* Security for Finance and Mortgage *Murabahah* Security has been offered by the Iranian banks called so far "Installment Sales Facility" or "*Furush Aghsati*" for buying commodity. Over the three decades some minor changes have been made with respect to the details of running process to *Murabahah*. In fact, bank should buy commodity on behalf of its clients in cash and delivered it to the client with a higher price which consist of cost of commodity plus a reasonable mark up. This amount will be paid in deferred time and on certain maturity.

In real transactions of *Murabahah*, clients do the process individually and bring their commodity invoices to banks to obtain facility. This is the point where problem arises, the Iranian banks are just content with commodity invoices which have been prepared merely by customers without seeking for necessary requirements. There is possibility for customers to change the type of facility to the second type, *Murabahah* for liquidity which is has been jurisprudentially *Batil* and not permissible based on *Shari'ah*. It sounds when Iranian banks only fulfill the forms rather than the substance, *Murabahah* contracts remain superficial. It is seen that customers even go beyond by making fake invoices to obtain funds for other purposes but commodity. According to a member of the Islamic Hi-Council of the TSE,<sup>17</sup> if the facility is used under the approved agreement it can be acceptable and *Halal*, but in other cases it is *Batil*. *Murabahah* contracts for financing activities such as developments via fake invoices has been a real practice so far in the Iranian

<sup>17</sup> Naser Makarem (2006), *Towzih-al-Masa'el*, Economics Section, Riba-free Mainlines, p. 234.

banks due to the lack of a strong surveillance mechanism for Ughods. Habibi, claimed that many of facilities offered by Iranian banks in forms of Islamic products such as *Murabahah* are doubtful for concluding usury (*Interest*). It represents that the Iranian banks are merely carrying Islamic labels not rather than dummy version of Islamic banks.

Another problem which has been condemned by the Iranian jurists is the higher rate of profits charged in the forms of different Islamic banking instruments which are not in accordance with *Shari'ah*. The Iranian banks used to calculate the rate of profits through the following equation:

$$p = \frac{s.i.(n+1)}{2}$$

Where:  $p$  is the amount of profit,  $s$  is the amount of principle,  $i$  is rate of profit and  $n$  is the number of payments over the loan time. In this case the payments consist of a lower amount of profit where a higher part belongs to principle. Some customers apply for the facility and after some months when they have paid the majority of principle and a minority of profit, they settle their loans. This leads to the banks' losses. Thus the authorities have introduced below the equation for Islamic products.

$$y = \frac{i/12 \times s \cdot (1+i/12)^n}{(1+i/12)^n - 1}$$

Where:  $y$  is monthly installments,  $i$  is profit rate,  $s$  is the principle amount and  $n$  is number of payments.

In this equation, profit is calculated monthly and installments at the beginning are mostly involved of merely profit rather than principle as long as profit is recovered. The recovery of the amount of profit compared to the principle at the beginning of the Islamic banking services given period may not be in accordance with the Islamic economics. Some of the Iranian jurists believe that there are still many significant actions which should be taken for purifying Iranian Islamic banking services from *Interest*. It seems that many of activities which are common practice in the Iranian banks are just alike commercial banks. Such activities as deposit accounts, overdrafting, business credits, credits on security and mortgage, long term credits, investments in banks and issuing securities by banks. After enacting the *interest-free* banking services in 1983, neither customer nor banks could implement the Ughods. Customers deposit their funds under the *Qardhul-Hassan* accounts without expecting any profit, but they could not lend their money to banks without expectations. Therefore, a competition arose among different banks to attract the public attention by grand prizes in lottery mode toward the *Qardhul-Hassan* accounts.

The Iranian Banks allocate a part of their income to these bonuses for tempting customers toward the *Qardhul-Hassan* accounts.<sup>18</sup> Jurists are concerned with renewing process of facilities contracts when clients failed to pay the installments which given through Islamic products. The combination of profit and principle

<sup>18</sup> Beizae, S. Ibrahim, (2007), "Present Situation of interest in Iran," Hamshahri online, 20<sup>th</sup> January, electronic copy is available in <http://www.hamshahronline.ir>, no.42176. Accessed 19/12/2017.

in order to calculate the profit for renewing the Islamic products contracts at maturity is challenging the Islamic scholars. Based on Javadi Mohammad Hussein Moshrefand Hamzeh Ghouchfard,<sup>19</sup> there are main bases on which the Islamic banking is grounded, Justice and Profit and Loss Sharing (PLS). According to the Justice Concept Banks shouldn't charge higher rate of profits and in order to follow the PLS, bank and customer should share profits and losses based on their risk and their capability.

### 3. Conclusion

The main principle of Islamic financial institutions is prohibition of Interest or usury. Interest is prohibited because it will lead to injustice and harm to the society. However, it is surprised to see in practice that Islamic financial institutions are still practicing Interest in these *Murabahah* transactions. Some of the Iranian jurists believe that there are still some significant actions which should be taken for purifying Iranian Islamic banking services from Interest.

Eliminating Interest in the banking system is an indispensable part of Islamic economic principles. Management and staff of this system are bound to conduct their business with conformity to Islamic business principles. These principles include honesty, justice and equity as ordained by Allah and practiced by Allah's Prophet. It is suggested that Islamic banks that have the *Murabahah* financing to practice true *Murabahah* in order to prevent Interest in the transactions and to achieve *Maqasid-Al-Shari'ah* (objectives of *Shari'ah*). The existence of Islamic benchmark could be the solution for this to replace the conventional benchmark which is still using rate of interest. The generation of consensus on permeable and non-permissible forms of *Murabahah* among the *ulama* will also help. The awareness about the *Murabaha* is required among bankers as well as costumers is required. There is constant need of *Shariah* advisory, *Shariāh* inspection, *Shariah* review, *Shariah* Audit, *Shariāh* supervision, *Shariāh* regulation in order to implement Islamic banking with letter and spirit without leaving any room for any kind of ambiguity or interest or usury in disguise.

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