Library Progress International *Print version ISSN 0970 1052*
Vol.44 No.3, Jul-Dec 2024: P.3553-3562 *Online version ISSN 2320 317X*

Original Article *Available online at www.bpasjournals.com*

The Historical Development And Contemporary Evolution Of Islamic Banking

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How to cite this article: Athul.S, Manu.T (2024). The Historical Development And Contemporary Evolution Of Islamic Banking. *Library Progress International*, 44(3), 3553-3562.

Abstract
Islamic Banking, also known as interest-free banking, operates in strict adherence to Sharia or Islamic law, differentiating itself from conventional banking through the prohibition of interest (Riba) and engagement in unethical business activities. This paper provides a comprehensive overview of Islamic banking principles, including profit and loss sharing, risk sharing, and the prohibition of speculation (Maisir) and uncertainty (Gharar). The historical development of Islamic banking, from its origins in the early Islamic era through its modern resurgence in the 20th century, is explored. Additionally, the paper examines the distinct features that set Islamic banking apart from conventional banking, emphasizing the ethical framework and social responsibilities inherent in Islamic finance. The growth and stability of Islamic financial institutions in the global market, particularly during economic downturns, highlight its potential as a viable alternative to traditional banking systems.

Keywords
Islamic Banking, Sharia Law, Interest-Free Banking, Profit and Loss Sharing, Risk Sharing, Ethical Finance, Conventional Banking

Introduction

Islamic banking, also called interest-free banking, is a system of banking operations that adheres to Sharia or Islamic law and is strictly guided by Islamic economics. In Islam, their complete activities are under the supervision of the Quran. Islamic economics is also based on the Quran. Islam strictly prohibited the collection of interests in financial matters. The main foundation of Islamic banking is the prohibition of interest. Islamic banking is the financial concept that avoids paying interest and receipts in its financial operations. Profit and loss sharing is the foundation of Islamic banking and it is strictly under the Islamic rule of transactions, which is known as Fiqh-al-Muamalat (Abdul Aris et al., 2013). This banking system is nowadays considered a great alternative to traditional banking. Islamic banks play a role as intermediates and collect money from the public as deposits without interest, distributing this money as loans to the public without interest. There are four main types of financing in Islamic banking: participatory funding, sale or trade-based financing, lease-based financing, and loan-based financing[i].

Conventional and Islamic banks carry out Similar intermediation tasks in the financial sector. They offer (a) activities for transforming assets, (b) management of payment systems, (c) brokerage operations, and (d) services for altering risks. Deposits, equity, credit, loans, and insurance are all components of asset transformation. The administration of payments includes check transmission, settlement, etc. Brokerage operations involve connecting buyers and sellers of instruments. Guarantees, securities, financial guidance, and custodial services are referred to as risk transformation (Mcmillen, 2015). Approximately 520 banks and 1,700 mutual funds globally uphold Islamic principles[ii]. During the global economic recession, Islamic banks showed incredible stability in meeting it. The Islamic financial sector expanded significantly between 2012 and 2019 and forecasted an increase of $3.7 trillion in 2014[iii].

2. The Features of Islamic Banking

- The Prohibition of Riba (Interest)
- Prohibition of Investing in Business Involved in Unethical Activities
- Profit and Loss Sharing
- Against Speculation (Maisir)
- Principle of Risk Sharing
- Participation of Income
- Against Gharar

2.1. The Prohibition of Riba (Interest)

Islam completely prohibits the collection of interest. Islam severely forbids interest, as is widely recognized and acknowledged. It rejects both paying and receiving interest. The Arabic word riba, which means unjust, is used in the Qur'an to refer to interest, which is sometimes known as "usury," which means "excess," "addition," or "growth"[iv].This is considered an exploitative gain in Islamic finance. According to the Quran and Hadith in several verses, it is said to be unjust and considered as a violation of Sharia (Ahmad et al., 2011).

"Those who devour usury
Will not stand except
As stands one whom
The Satan by his touch
Hath driven to madness.
That is because they say:
"Trade is like usury"
"But Allah hath permitted trade
And forbidden usury.
Those who after receiving
Admonition 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 (for ever)"
(Surah Al – Baqarah, verse 275)

"Allah will deprive
Usury of all blessing,
But will give increase
For deeds of charity:
For He loveth not
Any ungrateful
Sinner."
(Surah Al – Baqarah, verse 276)

"0 ye who believe!
Fear Allah, and give up
What remains of your demand
For usury, if ye are
Indeed believers."
(Surah Al – Baqarah, verse 278)

“That they took usury,
Though they were forbidden;
And that they devoured
Men's wealth wrongfully; -
We have prepared for those
Among them who reject Faith
A grievous chastisement”

(Surah An - Nisa’, verse 161)

There are two types of interest prohibition in Islam. The first one is Riba al Fadl or Riba al Bai and the second one is Riba al Nasia or Riba al Diyun[v]. Riba al Fadl indicates that although the two things traded in a given agreement are of the same type, one of them has a larger amount than the other. Riba al Nasia indicates, when the owner receives the exchanged item back after a delay in payment, an extra quantity is applied[vi]. Prohibition interest in Islamic banking results a positive attitude of humanity. Because of this, individuals are willing to assist others in need without expecting anything in return. so that the financial and social exploitation might be fixed (Suharto, 2018).

2.2. Investing in Business Involved in Prohibited Activities

Islamic finance is the activity of investing, trading, and banking in accordance with sharia law[vii]. One of the basic principles of Islam is the avoidance of unethical business which is unlawful in Islam. Drugs production, distribution and consumption of alcohol, pork farming, tobacco, pornography etc were strictly stood against these activities and considered these as sin and forbidden in Islam (Saiti & Abdullah, 2015). This is the cornerstone of Islamic business ethics and constitutes Islam's core ethical framework[viii].

“He hath only forbidden you
Dead meat, and blood,
And the flesh of swine,
And that on which
Any other name hath been invoked
Besides that of Allah.
But if one is forced by necessity,
Without wilful disobedience,
Nor transgressing due limits, -
Then is he guiltless.
For Allah is Oft-Forgiving
Most Merciful.”

(Surah Al – Baqarah, verse 173)

“0 ye who believe!
Intoxicants and gambling,
Sacrificing to stones,
And (divination by) arrows,
Are an abomination, -
Of Satan's handiwork:
Eschew such (abomination),
That ye may prosper.”

(Surah Al – Ma’idah, verse 90)

2.3. Profit and Loss Sharing

It is one of the vital standards of Islamic Banking, where the accomplices will share their benefit and misfortune as per the part they played in the business (Farihana & Rahman, 2021). There will be no assurance on the pace of the profits that the Muslims will fill the role of an accomplice and not a bank. In deposits, mortgage loans, and Sukuk and Mudarabah firms, the Islamic banking market very much practices profit and loss-sharing-based banking[ix]. PLS financial activities most commonly come under participatory financing. The concept of PLS between the consumer and the money supplier gives Islamic banks uniqueness (Khoutem & Hamza, 2014).

Musharaka and Mudarabah are the two primary forms of profit-and-loss financing. In a Musharaka contract, the bank and the client collaborate to finance a project or a transaction, and they share the risk proportionately based on their contributions. For Islamic banks, Musharaka contracts may provide a reliable source of income. A partnership is necessary for a Mudarabah contract between the financier (the Islamic bank) and the businessperson (Mudarib). The main characteristic of this operation is that Rab al Mal assumes all loss risk, while the Entrepreneur's losses are restricted to his efforts, barring any instances of carelessness or wrongdoing on his side(Khoutem & Hamza, 2014).

2.4. Prohibition of Investing in Gambling

Another important ban in the Islamic economic sector is gambling. Gambling is a loss situation that makes no extra worth to the general public (Abasimel, n.d.). In Arabic, it is commonly referred to as Maysir and Qimar. It pertains to any activity where a person's possessions are gained or lost only by chance. Numerous hadiths and verses in the Quran expressly forbid gambling[x]. In line with the current customs, resources, and valuable items in society, there are many types of gambling. These are together referred to in Islam as Maysir, which we might interpret as "games of chance," where the outcome is determined more by chance or luck than by any talent the participants may possess. A lot of Quranic verses strictly prohibited all types of gambling[xi].

“They ask thee
Concerning wine and gambling.
Say: "In them is great sin,
And some profit, for men;
But the sin is greater
Than the profit."
“They ask thee how much
They are to spend;
Say: "What is beyond
Your needs."
“Thus doth Allah
Make clear to you
His signs: in order that
Ye may consider-"

(Surah Al – Baqarah, verse 219)

“Satan's plan is (but)
To excite enmity and hatred
Between you, with intoxicants
And gambling, and hinder you
From the remembrance
Of Allah, and from prayer:
Will ye not then abstain?”

(Surah Al – Ma’idah, verse 91)

2.5. Principle of Risk Sharing

In economics transactions, risk sharing is encouraged by Islamic banks. If multiple parties share a risk based on Islamic banking principles, the risk burden is shared and mitigated between the parties. Therefore, it will improve the economic activity of the nation.

2.6. Participation of Income

Zakat is considered second in significance in the Quran. Zakat is a type of required almsgiving that has the power to alleviate millions of people's suffering. the word literally means "to cleanse." Muslims believe that paying the Zakat purifies the remaining portion of their income[xii]. People are not free to use Zakat however they like since the Quran outlines the types of recipients. Food grains, fruit, camels, cattle, sheep, goats, as well as gold and silver, as well as transportable objects are all subject to the Zakat tax (Hossain, 2012). After a year of ownership, it is payable annually. Ushr is a tax imposed on an individual's income. The base term "Asharah" means ten, while the derivative word "Ushr" means tithe or tenth part. Consequently, 10% of a person's salary is awarded in Ushr. During the period of Muhammad, Ushr was paid on agricultural output. On land that receives irrigation from rainwater or natural water, Ushr (one-tenth) is necessary. Each male member who could pay Zakat had to pay one dinar once a year during the time of the Prophet.

“(They are) those who,
If We establish them
In the land, establish
Regular prayer and give
Zakat, enjoin
The right and forbid wrong:
With Allah rests the end
(And decision) of (all) affairs.”
(Surah Al – Hajj, verse 41)

“And they have been commanded
No more than this:
To worship Allah,
Offering Him sincere devotion,
Being True (in faith);
To establish regular Prayer;
And to give zakat;
And that is the Religion
Right and Straight.”
(Surah Al – Bayyina, verse 5)

2.7. Prohibition of Gharar

The word Gharar means lack of knowledge or uncertainty. The prophet Muhammed banned commerce involving Gharar. According to Islamic financial principles, Muslims are not supposed to take part in vague and uncertain transactions. According to Islamic rules, all parties must controll their transactions reasonably. In addition, complete information must be shared with both parties so that profits and losses are shared equally. There are several instances of Gharar-based transactions, such as selling offspring in the womb of a pregnant animal, fish in the pond, or birds in the sky. These transactions are banned because the seller’s ability to deliver these items is uncertain.

Islamic banking principles guide us to invest in industries that help achieve the financial and social goals Islam sets. They were designed for the success of the economy. So, it is a way to prevent our money from being invested incorrectly.

“o ye who believe!
Eat not up your property
Among yourselves in vanities:
But let there be amongst you
Traffic and trade
By mutual good-will:
Nor kill (or destroy)
Yourselves: for verily
Allah hath been to you
Most Merciful!”
(Surah Al – Nisa’, verse 29)

“And do not eat up
Your property among yourselves
For vanities, nor use it
As bait for the judges,
With intent that ye may
Eat up wrongfully and knowingly

A little of(other) people's property."

(Surah Al – Baqarah, verse 188)

3. History of Islamic Banking

There are two phases to the growth of Islamic financial institutions. The first stage can be understood as taking place throughout the times of the Prophet Muhammad, the Umayyads, the Abbasids, and the four revered Caliphs. Initiating the second phase in the 1950s (Rahahleh et al., 2019). The Quran is the Islamic financial system's fundamental and most important factor. The Quran is the holy book of Muslims. According to Muslims, the Quran is the words of Allah, which were delivered to Prophet Muhammed, who is the messenger of God. Prophet Muhammed revealed these messages to the common people of Arabia. Then he started his missionary works to spread the ideas of the Islamic religion and the Quran worldwide. Before the advent of Islam, the condition of Arabia was in its worst order. This period is commonly known as the Jahilliya or Age of Ignorance. Every aspect of political, social, religious, and economic life was in the poorest possible order and at the most basic level. The Jahilliya tribe lacked a Prophet, a revealed text, and a distinct theological philosophy. The Dark Ages also lacked a functioning political structure and knowledge of proper governance[xiii].

The economic condition of pre-Islamic Arabia was also in a worse order. There weren't any agricultural and mineral products. The economic status of the people was very pathetic. Some people, like Jews, controlled 90% of the wealth of that time. The Jews gave money to the common people with a high rate of interest, and they treated their debtors very badly. With these worse conditions, the whole region stepped into darkness. This began to change after the prophethood of Muhammed. Islamic banking has its roots in the early Islamic era when the prophet Muhammad himself served as a reliable agent for his wife's business dealings. After getting the revelation from the god and the prophethood, Muhammed began to spread ideas of Islam. At first, Khadija accepted his mission, which Ali, Abu Bakr, Uthman, Abdur Rahman, Zayd, Zubair, and Talha continued. Within a short time, Islamic ideas began to spread. This created more problems for the Quraysh tribe, the most important one in Arabia. They began to suppress Muhammed and his followers. These suppressions led to the first and second migrations to Abyssinia, resulting in the Hijra from Mecca to Madinah. When the Muhammed arrived in Madinah, the Madinites named Muhammad as their leader, and he took control of the Madinah. Prophet Muhammad signed a covenant known as the Madinah Charter after assuming control of Madinah. The Madinah Charter is the most significant agreement that gave Muslims a strong, tangible foundation. Later, it was regarded as the 'constitution of Madinah.'

Instead of political, social, and religious reforms, he paid special attention to economic reforms. Prophet Muhammed firmly stood for the well-being of the completely exploited class. Usury or interest was very common at that time, and the usury was practiced by Jews, and they treated their debtors in a very bad manner. At first, Prophet Muhammed abolished the system of usury, and Islam made usury haram, which is against the basic concept of Islam. Prophet Muhammed and Islam also introduced the main pillars of Islamic finance, such as Zakat, Sadaqah, and Fitr.

The foundational stones for the Muslim administration's taxation system were created by the Prophet Muhammad. Before the arrival of Islam, no one in Arabia was aware of their income and expenses. The central government's foundation was laid by the prophet Muhammad. In Madinah, the Prophet Muhammad established the first public treasury. The Islamic government had five sources of income during the time of the Prophet: Zakat (Poor Tax) or Sadqah (Voluntary Alms), Jizya (Capitation Tax), Kharaj (Land Tax), Ghanima (Spoils of War) and Al Fay (State Lands). The Prophet also engaged in Musharakah or Shirkah (sharing of profits and losses), interest-free loans (Qard Hasan), future sales (Bai Salam), currency exchanges, and leasing, among other practices (Rahahleh et al., 2019).

After the era of Prophet Muhammed, these financial practices were continued by the pious caliphs. The first statutory zakat system was established by the caliph Abu Bakr[xiv]. After the death caliph Abu Bakr, caliph Umar Ibn al Khattab came to power. He made many reforms in all political, social, and especially in economic fields. Caliph Umar introduced the Bait ul Mal, the first public treasury in the empire[xv]. Uthman and Ali followed these economic reforms, the last pious caliphs. They strengthened the Prophet's and former caliphs' financial policies.

After the death of Ali, the Umayyads and Abbasids came into power. The financial oversight of the empire clearly benefited from the Umayyad and Abbasid dynasties' leadership. During this time, Islamic dirham and dinar coins were first issued. During the tenure of the Abbasids, the central treasury Bait ul Mal was increased, and dinars and dirhams served as the unit of exchange (Rahahleh et al., 2019). Harun al Rasheed established the House of Wisdom (Bayt Al-Hikmah) during the Abbasid era in order to foster new economic ventures, advance knowledge, and further the imperial financial progress[xvi]. These periods of financial reforms were considered the first phase of the history and development of Islamic financial institutions.

The second phase was started in the 1950's. The second stage of Islamic banking growth may be divided into two categories: before and after 2000. Before the 1950s, there were ideas about creating Islamic financial institutions. The idea of Islamic banking was first made public by Islamic economists and philosophers in the early 1960s. While contemporary Islamic financial institutions were first introduced in 1963, the current form of the practice didn't emerge until 1975, when banks were founded and given the mandate to function under Shari'a laws and principles. Since then, one of the fastest growth rates has been seen in the Islamic financial sector of the global banking business[xvii].

The first Islamic banking model in the world is typically called Mit Ghamr Savings or Social Bank, founded in Egypt in 1963. Although the word "Islam" does not appear in its name, it is known that the bank was founded on and operated following Islamic laws and principles (Orhan, 2018). Cairo saw the foundation of the first Islamic bank in the urban area. 1971 the Nasser Social Bank was founded and opened for business in 1972. The bank has an independent position as a public authority. Its principal social objectives include providing aid to the underprivileged, Qard Hasan for small enterprises on a profit-sharing basis, and loans for university and higher education to deserving students[xviii]. The Amanah Islamic Bank was established in the Philippines in 1973. The Bank adopted the "no interest concept" in Islamic banking and partnership principles in 1974. However, the Bank was less competitive in the country's traditional banking industry due to the lack of acceptance and support for Islamic banking[xix].

A convention of Muslim country finance ministers held Jiddah in December 1973 and resolved to establish the IDB as an international financial organization. In October 1975, the Islamic Development Bank had its inaugural meeting[xx]. Dubai Islamic Bank, the first contemporary commercial Islamic bank, was founded in 1975 by Haj Saeed bin Ahmed Al Lootah. In May 1977, Faisal Islamic Bank was founded in Khartoum, Sudan, and commenced its operations in 1978[xxi]. In the same year, Islamic financial institutions were established in Egypt and Kuwait. In 1978, Luxembourg became the home of Europe's first Islamic bank[xxii]. The Islamic Insurance Company of Sudan, the first takaful (Islamic insurance) business, was founded in 1979[xxiii]. Pakistan is the first country to "Islamize" state-level banking procedures in 1979.

The first official Sharia-compliant bank in Malaysia, Bank Islam Malaysia, opened its doors in July 1983. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was founded in Bahrain by the IDB on February 26, 1990. Islamic windows were first established in traditional banks in the middle of the 1990s. Bank Muamalat, Indonesia's first Islamic bank, was founded in 1991. Islamic financial institutions began to expand quickly in the early days of the 2000s. Numerous novel products were released, including credit cards, retail banking, and real estate finance. The Islamic Financial Services Board (IFSB), an international body that sets standards, was founded in Kuala Lumpur in 2002. Between 2004 and 2008, capital investment in Islamic finance products increased significantly as oil prices climbed and petrodollars flowed through oil-producing countries. The nation's first high street bank to adhere to Sharia law, the Islamic Bank of Britain, launched in London in September 2004. The Dubai Financial Market, the primary stock market in Dubai, announced in November 2006 that it was reorganizing to become the first Islamic exchange. Singapore introduced its first Islamic bond scheme in January 2009. Indonesia sold its first sukuk, or sharia-compliant bonds, in February 2009[xxiv].

4. Islamic Banking in Present Global Scenario

Islamic banking has witnessed significant growth and development globally, emerging as a substantial financial industry segment. The following key points can characterize the current status of Islamic banking:

4.1. Market Size and Growth: Islamic banking assets have grown exponentially, with the total assets projected to reach $3.69 trillion by 2024. This growth is driven by increasing demand for Sharia-compliant financial services, particularly in Muslim-majority countries and regions with significant Muslim populations (Adewale & Barakat, 2023).

4.2. Geographic Distribution: The Islamic banking sector is predominantly concentrated in the Middle East and Southeast Asia. Key markets include Saudi Arabia, Iran, Malaysia, the United Arab Emirates, and Kuwait. These countries have established robust regulatory frameworks to support the growth of Islamic finance.

4.3. Global Presence: Islamic banking is expanding beyond traditional markets, with notable growth in regions such as Africa, Europe, and North America. Countries like the United Kingdom and the United States have seen the establishment of Islamic financial institutions and the introduction of Islamic finance windows in conventional banks.

4.4. Regulatory Frameworks: Regulatory bodies like the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB) have been instrumental in standardizing practices and ensuring compliance with Sharia principles. These organizations provide guidelines and standards that enhance the credibility and consistency of Islamic banking practices globally.

4.5. Product Innovation: Islamic banks are increasingly diversifying their product offerings to cater to a broader range of financial needs. Products such as Sukuk (Islamic bonds), Takaful (Islamic insurance), and various profit-sharing investment accounts are gaining popularity. These innovative products provide competitive alternatives to conventional financial instruments (Bhatti & Khan, 2008).

4.6. Financial Inclusion: Islamic banking is playing a crucial role in promoting financial inclusion, particularly in regions with large unbanked populations. By offering Sharia-compliant financial services, Islamic banks provide access to finance for individuals and businesses that may be excluded from conventional banking systems due to religious reasons (Demirguc-Kunt et al., 2014).

4.7. Challenges and Opportunities: Despite its growth, Islamic banking faces challenges, including the need for greater standardization, developing a deeper secondary market for Islamic financial instruments, and addressing misconceptions about Islamic finance. However, opportunities abound as the demand for ethical and socially responsible banking grows, and technological advancements open new avenues for product development and service delivery (Shaikh, 2014).

4.8. Economic Resilience: Islamic banks have demonstrated resilience during economic downturns, attributed to their risk-sharing principles and avoidance of speculative investments. This resilience has bolstered their reputation as stable and reliable financial institutions.

Overall, Islamic banking continues to expand its footprint globally, supported by a growing demand for ethical finance, robust regulatory frameworks, and innovative financial products. As it evolves, Islamic banking is poised to play an increasingly significant role in the global financial system (Beck et al., 2013).

5. Conclusion

Islamic banking, with its foundation deeply rooted in Sharia principles, presents a unique and ethically driven alternative to conventional banking systems. The prohibition of Riba (interest), emphasis on profit and loss sharing, and the avoidance of investments in unethical activities underscore the distinctiveness of Islamic banking. This system not only adheres to religious mandates but also promotes financial inclusion and social justice. The historical evolution of Islamic banking, from its origins during the time of the Prophet Muhammad to its resurgence in the mid-20th century, highlights its enduring relevance and adaptability. Islamic banking has expanded significantly across the globe, gaining traction not only in Muslim-majority countries but also in non-Muslim regions, demonstrating its universal appeal and potential for growth.

As Islamic banks continue to innovate and diversify their product offerings, they face both challenges and opportunities. The need for greater standardization, enhanced regulatory frameworks, and increased public awareness remains crucial. Despite these challenges, the resilience and ethical foundation of Islamic banking offer a promising path toward a more inclusive and stable financial system. In conclusion, Islamic banking stands as a testament to the viability of finance that aligns with ethical and religious principles, providing a sustainable and socially responsible alternative to conventional banking. Its continued growth and evolution are poised to make significant contributions to the global financial landscape.

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