

# ISLAMIC FINANCE AFTER THE GLOBAL FINANCIAL CRISIS

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## Introduction

Some economists suggest that the recession is over, or nearly over, and that we have begun to recover. However, it is still too early to truly determine how close we are to economic recovery as there is a substantial amount of allocation and valuation to be certified on assets; this is a particular challenge as institutions are not entirely certain of all their assets and liabilities due to the complex nature of the products and transactions. In fact, the latest economic recession in Europe, which may result in a double-dip if not effectively managed, has had a deleterious impact on the global economy. The implications of what has transpired worldwide will therefore be unclear for a substantial amount of time since the effects of the crisis keep reverberating. This situation has encouraged academics and practitioners to explore solutions that aim to safeguard the global economy from such financial turmoil in the future.

The recent crisis is one of the worst financial crises that the world has witnessed since the Great Depression. The Great Depression of 1929 was concentrated mainly in the United States and the current crisis started in the U.S. as well; however, its dominant effect has spread globally, which illustrates the interconnectedness of today's global financial system. Governments and central banks have had to intervene in order to address the turmoil in the markets by acquiring the "toxic assets" of financial institutions, guaranteeing deposits and cutting interest rates, among other measures. During the recent recession, the world has experienced a near complete economic meltdown. We have heard various voices echoing the virtues of a comparatively nascent alternative financial system, such as the Islamic financial system, which constitutes barely 1 percent of the global finance and is still developing.<sup>1</sup> Practitioners, regulators, academics and economists are now vigorously analyzing the Islamic financial system to ascertain its

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resilience to financial crisis. Their analysis is not limited to testing the strengths and weaknesses of the Islamic financial system, but also entails testing whether the Islamic financial system provides a model that could help prevent future financial turmoil in the global financial system.

As the effects of the current economic crisis are well-known, it is more appropriate to discuss its causes in brief and to study the unique features of Islamic finance that offer an alternative system, which may be more pertinent than its conventional counterpart. We have witnessed the fall and failure of major investment banks, and most people are still uncertain of the correct valuation of their true liabilities as the asset values of these banks keep eroding.

The recent crisis is not due to any single factor but rather a multitude of factors and has affected the financial markets across the world. Financial institutions were thought to be too big to fail, and the likelihood of such failure in the global financial industry was absolutely unthinkable. Economists have said that some of the primary factors responsible for the crisis were lax regulations, excessive leveraging, short selling, greed and lack of physical substance in the assets backing of products. Furthermore, the rating agencies rated these products highly because they were heavily insured, and buyers bought them based on the bottom line of their return on investment without understanding the product or looking at the underlying asset. Quite simply, there was no substantial underlying asset. To illustrate the phenomenon, let us consider the example of an asset worth \$10 million, which was packaged, re-packaged, derivatized. Before we realized it, the debt was \$100 million and the asset was still only \$10 million. When the product was unraveled, the underlying asset got impaired. These kinds of phenomena have led to a crisis in confidence, which was more rapid than anyone expected. Large invested sums suddenly vanished, but were they really there in the first place? This was also the case for credit default swaps, as the conventional financial system allowed multiple debt creation on an asset without there being a real underlying transaction. These factors all contributed to the economic crisis.

Economically speaking, banks and other financial institutions provided subprime loans and other toxic market assets under very lax regulations, which ultimately undermined investors' confidence.<sup>2</sup> For some time now, there have been signs of the impending meltdown: industrial production, housing starts and confidence in general have been down, leading to the downward trend in retail as a result of lax financial regulations.<sup>3</sup> The Bernie Madoff case is a prime example of a lack of regulation; attempts by investors to draw attention to their concerns were ignored. Madoff's investors were the doyens of the industry.<sup>4</sup>

## **Causes of Crisis**

Some of the crisis' causes also relate to the unprecedented leveraging and poor lending criteria utilized by financial institutions.

Leverage levels that had become the norm permitted the baseless hike in asset valuation and rise in consumption to unacceptable levels, which could not be sustained. For example, before Lehman Brothers filed for bankruptcy in September 2008, its leverage ratio was 30.7:1,<sup>5</sup> whereby a drop of 3.3 percent in its assets value would have eradicated its equity and rendered the company insolvent.<sup>6</sup> This fact raises questions as to why the management was not alarmed by that kind of high leverage through results of Value at Risk (VAR) analysis and other stress testing techniques. And if these techniques were sending alarming signals to the management, why were the regulators, who were permitting such risky business conduct, blind to them? In some ways, the failure of Lehman Brothers was the turning point for the further loss of confidence in the market. It shook the regulators of the industry and brought to their attention the necessity of a supervisory function for the industry.

Another contributor to the crisis was the unregulated trading of uncertain and speculative financial instruments and securities such as derivatives. Before the crisis, industry experts described these as "financial weapons of mass destruction."<sup>7</sup>

Industry practitioners and stakeholders hold the view that structurers, sellers and sophisticated/professional investors of the financial markets were well aware of the nature of products and of the possibility of a downgrade of the products due to poor quality of underlying assets/investments. The professional investors and sellers entered that high-risk market deliberately, as they were completely swayed by lucrative and unprecedented gains arising from those transactions. This view is based on the hypothesis that when bankers were happily involved in advancing NINJA (No Income No Job or Asset) loans to the borrowers, bankers knew they were involved in subprime lending; hence, they should not have been surprised by the outcomes.

It is indeed surprising that these practices by financial markets participants did not end at subprime lending; rather, with the help of smart structurers, the financial markets participants managed to package the subprime assets and securitize them. They eventually converted them to disastrous innovative instruments such as collateralized debt obligations (CDOs), which were insured, rated and sold.<sup>8</sup>

There was also a heavy reliance on rating agencies by all market players, resulting in huge increases in their revenues. For instance, "Moody's revenues from structured finance ratings increased from a little more than \$100 million in 1998 to more than \$800 million in 2006, representing more than

80% of its total rating revenues.”<sup>9</sup> Another interesting point to note is the role of regulators in the financial crisis. When all the facts of the crisis became public, one was left to wonder why these shockingly risky practices (i.e., rating of structured finance products) did not alarm regulators. This is an issue that needs to be rectified to satisfy the masses now suffering the consequences of the crisis. One particular consequence is growing levels of unemployment and insolvencies. When we consider the issue of lax regulations, we should focus not only on the U.S. regulations but also on the regulations of other jurisdictions.

Bearing in mind that various factors contributed to the recent financial turmoil, practitioners, regulators, and academics have a duty to highlight the deficiencies of the financial system on a timely basis by keeping a close eye on markets and introducing corrective measures, mechanisms and regulations in order to prevent a future occurrence of such a crisis. The recent financial crisis illustrates that if the system is run in a *laissez-faire* style, over a period of time it self-destructs through the financial bubbles. Certain financiers and scholars hold the view that “bubbles have a built-in asymmetric nature: it takes a lot longer for them to emerge, but they implode in short order.”<sup>10</sup> Many believe Islamic finance has been protected from such bubbles and may provide the panacea to the financial ills currently experienced in the global economy.

### **Salient Principles of Islamic Finance**

Islamic finance is premised on core principles of Islamic commercial law as extrapolated from basic rules laid out in the Quran and Sunnah. Interest, debt trading, gambling, speculation, ambiguity of contract, high leveraging, selling unowned things and dealing in items such as pork, alcohol, tobacco, weapons/arms and pornography, are forbidden. Short selling is also prohibited in Islam, with certain exceptions such as *salam* and *istisna'* (these contracts are valid only if executed according to the rules and regulations for these contracts stipulated in *shari'a*), where the goods are not readily available and need to be produced before delivery.<sup>11</sup> Furthermore, money is simply a medium of exchange and a measure of value. Money should only be used to finance projects, trade goods and services, and create real economic benefit. It cannot be used as a commodity that can be freely traded with interest (*riba*) as the charge for the commodity.<sup>12</sup>

The interest-based debt contracts prevalent in the conventional system are liable to experience financial turmoil and therefore are subject to instability. However, the recent crisis has highlighted the soundness of the equity and trade-based nature of the Islamic finance system endorsed by *shari'a*.

Islamic finance prohibits the creation of debt through direct lending and borrowing, hence prohibiting excessive leverage, which is one of the root causes of the crisis. The creation of debt, through the sale or lease of real assets (via the *murabahah*, *ijarah*, *salam* or *istisna'* modes of financing) is permitted subject to the following conditions:

- The underlying assets are real and not imaginary or notional.
- The seller or leaser should own the goods being sold or leased.
- The transaction is genuine, with the intention of giving and taking delivery.
- The debt cannot be sold and thus the risk must be borne by the financier.

These conditions help ensure that transactions are related to genuine economic activities and do not let the debt levels rise far above the real economy.

In its ideal form, Islamic finance is expected to raise the level of equity and profit and loss sharing. Some mainstream economists have also favored and advocated this phenomenon. These economists hold the same view that “in an ideal world, equity lending and direct investment would play a much bigger role.”<sup>13</sup>

### **Islamic Finance and Recent Financial Crisis**

Islamic finance is concerned with more than just making profits. Every investment proposition should be tested against the *maqasid al-shari'a* (objectives of the *shari'a*), where the primary objective is to benefit people and provide greater justice. Such proposition should not cause any harm to either parties and must bring about mutual satisfaction. Each party to a *shari'a*-compliant transaction is required to share the risk rather than shifting the entire loss to the entrepreneur. Laldin is of the view that currently *shari'a* boards are concerned with the *shari'a* compliance of the products and contracts, and not the economic consequences thereof.<sup>14</sup> This situation, of course, neither guarantees the future of Islamic finance per se nor the resilience of the financial system against financial meltdowns and turmoil. The mere form of these *shari'a*-compliant products and alternative *shari'a* compliant banking system will not bring about the desired results until the substance thereof becomes *shari'a* compliant. The virtues and socio-economic benefits of this alternative banking system must be distilled down to the masses, society and, more precisely, to the economy.

Considering the key principles of Islamic finance, some of which have been briefly mentioned in the preceding paragraphs, it appears that Islamic finance, if practiced in its true spirit and monitored with risk management techniques and regulations customized or developed on de novo basis, will

ensure economic growth and resilience of financial systems across the globe. However, for Islamic finance to become a viable alternative, appropriate and comprehensive legal frameworks are needed, as are standardization, harmonization and a degree of uniformity so that Islamic finance can be applied across multiple jurisdictions.<sup>15</sup>

Although at first it seemed that Islamic banks were more immune to the crisis, they too suffered due to the general diminution in the value of assets, as they function within the same financial system as conventional banks. The impact was less severe because Islamic finance products are asset-based or backed, as is required of Islamic loans and investments. Also, the prohibition on derivatives protects Islamic finance from having toxic products on its books. However, Islamic finance was not completely immune from the negative effects of the crisis. Consultants, researchers and academics believe that various factors contributed to this. One of these factors was the availability of limited range of permissible and profitable investment avenues, making the Islamic financial system “vulnerable to sector-specific shocks.”<sup>16</sup> Also, as part of global financial system, Islamic financial systems could not remain insulated from the worldwide fluctuation in valuation of assets.<sup>17</sup>

Islamic finance researchers say that today’s Islamic banking system is not crisis-proof, and will not be completely resilient to future financial crises and bubbles. This view is backed by the results of Hasan and Dridi’s comparative analyses of the stability and resilience of the Islamic and conventional banking systems before and during the recent crisis.<sup>18</sup> Hasan and Dridi analyzed the performance of several conventional and Islamic banks in selected countries with a dual banking system. They concluded that Islamic banks behaved differently than their conventional counterparts in selected jurisdictions for both pre-crisis and post-crisis selected periods. Hasan and Dridi analyzed selected jurisdictions instead of performing a global analysis, which led to the conclusion that Islamic banks performed better than their conventional counterparts during the crisis. Their analysis highlighted different underlying reasons for better comparative profitability of the Islamic banking system over the conventional banking system in 2008 and the converse phenomenon in 2009 due to a decline in the asset growth rate of some countries such as Bahrain and Egypt. Hasan and Dridi’s analysis shows that the adverse effect of the financial crisis in 2008 was limited in the Islamic banking industry due to the business models of Islamic banks, while the weaknesses in risk management adversely affected their profitability in 2009.

The Islamic banking system, if practiced and implemented in its true spirit coupled with appropriate regulations, can be a cure for many of the financial ills created by a conventional banking system based on the

philosophy of money as a commodity. It is evident from the history of financial crises that the conventional banking system's philosophy has resulted in the exploitation of the masses and has debased the common good for the society and economy. The solutions put forth by experts to overcome the shortcomings of current conventional system, are similar to the essential building blocks and principles of the Islamic banking system.

### **Challenges and Future Course of Action**

In some sense, Islamic finance has been protected from the current crisis due, not only to the nature of the requirements of the *shari'a* criteria, but also to the actual size of the Islamic finance industry within the entire global finance market. Janahi holds the view that "Islamic Finance's non-exposure to products such as derivatives was partly due to the fact that many of the Islamic Finance bankers did not understand it and those who did understand it, the Scholars, did not understand it and those that did correctly dismissed them as being non-*shari'a* compliant and therefore un-investable."<sup>19</sup>

The fact that the Islamic finance industry was not exposed to derivative products—protecting it, to an extent, from severe ill-effects of the crisis—does not negate the need for the development of comprehensive legal and regulatory framework. Besides the development of the framework, industry stakeholders must carry out extensive collaborative research to determine an efficient, resilient and innovative range of Islamic finance products.

#### *Regulatory Framework*

One of the lessons that the Islamic finance industry can glean from the recent financial crisis is the necessity of designing and developing a comprehensive and dynamic regulatory framework, created specifically for the purpose of adhering to the rules and regulations of Islamic law that are compliant with *maqasid al-shari'a*. The longer it takes to establish such framework, the longer the Islamic financial system will remain vulnerable to negative incentive structures similar to the conventional finance offerings. This is mainly due to the fact that Islamic finance is currently operating in a framework based on the conventional model.

In recent years we have seen the first defaults on *sukuk*.<sup>20</sup> Most of them have been unsecured *sukuk* and investors have begun asking about the assets underpinning those *sukuk*. Where are the assets? Why can't they be liquidated and the investment returned since Islamic finance is supposedly based on tangible assets and real economic activity? These kinds of queries should provoke practitioners, *shari'a* scholars, academics and legislators to address these legal and insolvency issues confronting the nascent Islamic finance industry.

Hence, the recent *sukuk* defaults and disputes have in reality tested the robustness of the Islamic finance system and have identified the areas of requisite legal reforms.<sup>21</sup> It is interesting to note here that despite the fact that the structure of the *sukuk* in question was technically Islamic or *shari'a* compliant, it behaved no differently from a conventional bond. Chapra holds the view that Islamic banking is currently trying to mirror the conventional banking industry by using different *hiyal* (legal stratagems) and thereby replicating some unsuitable conventional banking practices with an Islamic label.<sup>22</sup>

Industry academics and experts have emphasized the need for a functional institutional framework for Islamic finance and the creation of a new architecture in which the system will operate.<sup>23</sup> We cannot wait for financial turmoil to hit the Islamic finance industry before we develop and implement appropriate legal and regulatory frameworks. Besides the rules and regulations, “a unified administrative agency to uniformly and globally enforce the rules of the framework across jurisdictional boundaries” should also be established.<sup>24</sup> We must ensure proper regulation and accountability from those with a fiduciary responsibility.

#### *Research and Development*

The recent crisis underscores the fact that the Islamic finance industry was saved from the deadly effects of the crisis initially because of the fundamental prohibitions inherent in the industry, which restrained it from dealing in highly speculative and leveraged products and derivatives. However, recent developments in the Islamic finance industry have made it clear that this industry is not completely free from a potential future crisis; hence, there is a profound need for more research in product development. The lack of research initiative led to the availability of limited *shari'a*-compliant asset portfolio options for Islamic finance institutions. On one hand, the Islamic banks' heavy exposure to the real estate sector did adversely affect the Islamic banks. On the other hand, due to lack of liquid *shari'a*-compliant asset classes, some Islamic banks invested in equities, exposing themselves to the correction of stock markets during the recent crisis. Some of the industry's losses can be attributed to some of the reverse-engineered financial instruments whose *shari'a* authenticity and financial viability have been scrutinized much more since the recent crisis.

In order to sustain and maintain the appeal of the industry, enormous and immediate research endeavors are needed to come up with innovative products for the industry. These products should not only have religious appeal and facilitate the public welfare (one of *maqasid al-shari'a*), but must also have sound financial sustainability, which would ensure growth of the industry throughout the world, regardless of creed and region.<sup>25</sup>



The Islamic finance industry must come up with authentic products that address the long-standing liquidity management issue. Industry players and practitioners have been raising this issue for some time. They have pointed out that the maturity mismatch in Islamic banks is far more distributed compared with conventional banks. The distribution of liabilities is skewed more toward the short and medium term while on the asset side the generally available options are for medium to long term.<sup>26</sup> Furthermore, the industry's excessive exposure to the real estate sector, dependence on commodity *murabaha* structures (developed as a temporary solution, but which as been employed now for roughly thirty years)<sup>27</sup> and negligence of other important sectors like financing of exports and imports, are major inhibiting factors restraining the growth and development of the Islamic finance industry.<sup>28</sup> These inhibiting factors require extensive collaborative research by *shari'a* scholars, practitioners, academics and experts, who must come up with viable and lawful solutions. It should be noted here that institutions like International Shariah Research Academy for Islamic Finance (ISRA) were established to develop future generations of scholars and practitioners. These future generations will be able to tackle the current challenges in the industry, undertake the required research and recommend viable and lawful solutions.<sup>29</sup>

Generally, the risks inherent in Islamic finance are similar to conventional finance; however, in some cases, the risks are more complex than those encountered by the conventional banking industry. Hence, it is incumbent upon the industry stakeholders to contribute to the development of a robust risk management system for the Islamic banking industry. The risk management system should continuously monitor and correct the risks, such as concentration of investment in a particular industry/sector, liquidity and operational risks faced by the industry, etc. Needless to say, regulators must play the key role here, as the academics, practitioners and *shari'a* scholars can only contribute toward the development of an effective and efficient system while the enforcement (through appropriate onsite or offsite supervision techniques) would remain the prime duty of the regulators.

## Conclusion

The underlying impetus of this chapter is to analyze ways to make the Islamic banking system more resilient. Studies on Islamic finance thus far have established the fact that the principles of Islamic finance are sound enough to take care of most of the obvious and known flaws in the conventional financial system. However, this fact should not make the stakeholders of the industry complacent, rather it should stimulate them to fill the loopholes of the system in order to provide an even more resilient global banking

system.<sup>30</sup> It is incumbent upon the industry's stakeholders to strive for the development of legal and regulatory framework and risk management techniques for the Islamic finance industry. Furthermore, transparency requirements should be enforced as legal and regulatory requirements as they will strengthen *shari'a* scholars' resistance to the excessive use of *hiyal* to safeguard the reputation of the profession of *shari'a* experts.<sup>31</sup> Transparency of *fatawa* will also prevent the possible transgression of basic *shari'a* principles for trade and finance. These fundamental *shari'a* principles, if properly and strictly adhered to, will guarantee the growth of the global economy and public welfare, and prevent the occurrence of future financial turmoil and crisis.

## Endnotes

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10. Abbas Mirakhor has quoted George Soros's quotation on financial bubbles and the authors also agree with the idea conveyed in the quotation. Quotation available as of March 2011 at [http://webcache.googleusercontent.com/search?q=cache:ZGrNOFmH8mwj:www.islamonline.net/servlet/Satellite%3Fc%3DArticle\\_C%26cid%3D1262372421505%26pagename%3DZone-English-Living\\_shari%252FLSELayout+george+Soros+and+financial+crisis+bubbles+have+a+built-in+asymmetric+nature:&cd=1&hl=en&ct=clnk&gl=uk&source=www.google.co.uk](http://webcache.googleusercontent.com/search?q=cache:ZGrNOFmH8mwj:www.islamonline.net/servlet/Satellite%3Fc%3DArticle_C%26cid%3D1262372421505%26pagename%3DZone-English-Living_shari%252FLSELayout+george+Soros+and+financial+crisis+bubbles+have+a+built-in+asymmetric+nature:&cd=1&hl=en&ct=clnk&gl=uk&source=www.google.co.uk).

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23. Experts and academicians such as Mushtak Parker, Umer Chapra, Ahmed Al Janahi and many more have emphasized the need to establish appropriate institutional frameworks for the industry.

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