

PRIMARY RESEARCH

An Empirical Investigation of the Regulatory and Non-Regulatory Challenges of the UK Islamic Retail Banking

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Abstract. The paper examines the regulatory and non-regulatory challenges facing the growth of Islamic retail banking in the UK. Our analyses reveal that policy-makers and regulators in the UK have taken many actions to encourage the growth of Islamic finance. However, despite the suitable regulatory environment, UK Islamic retail banks have so far failed to convince consumers of the credibility of their services due to the questionable structure of their products. Intriguingly, the current system of Shari'ah assurance is perceived to have several weaknesses which could perhaps lead to ambiguity, confusion and loss of credibility in the eyes of consumers. Our findings also reveal several key religio-ethical considerations. In particular, we highlight that the future of UK Islamic retail banking is bleak unless these issues are urgently tackled by creating a more transparent Islamic banking system and improving the current structure of Shari'ah-compliant products to preserve the expected ethical and societal legitimacy of Islamic banks.

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INTRODUCTION

Islamic banking has come a long way since the humble start in Egypt in the early 1960's (Chong & Liu, 2009). In the 1970's, Islamic banking started to gain popularity in several predominantly Muslim countries, including the Gulf States, Iran, Pakistan and Malaysia (Benamraoui, 2008). Islamic banking is now part of several banking systems around the world, either through an integrated part of the banking sector or in a parallel system, IMF, 2015. In the West, the UK, was the first country to allow Islamic banking on its shores in the 1990's with the then FSA granting a license to the Al-Barakah Bank (Belouafi & Chachi, 2014). Since then, the UK has experienced steady but volatile growth in this type of banking

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(International Financial Services London (IFSL), 2010). The welcoming approach adopted by UK regulators has allowed several institutions to offer Islamic financial solutions, both in the retail and wholesale sectors. However, despite the UK government's efforts in pursuing further development in the industry, Islamic banking has failed to reach a higher status than just a "niche" in what is perceived to be a large market.

Parallel with this rapid rise in the demand for Islamic financial solutions is the increase in the diverse number of academic studies that have specifically researched this alternative form of finance. Extant literature has predominantly focused on examining the operational performance of Islamic banks (for example, Beck *et al.*, 2013; Siddiqui, 2008) or on issues related to ethics (for example, Aribi & Gao, 2011; Darus *et al.*, 2015; Haniffa & Hudaib, 2007; Nawaz, 2017; Ullah *et al.*, 2014, Ullah *et al.*, 2016) and corporate social responsibility and micro-finance (for example, Blanco-Oliver *et al.*, 2016). Several studies have also made a worthwhile contribution to the literature on corporate governance frameworks in such institutions (for example, Abu-Tapanjeh, 2009; 2007; Chapra & Ahmed, 2002; Dalwai *et al.*, 2015; Garas & Pierce, 2010; Grassa & Matoussi, 2014; Mollah & Zaman, 2015; Safieddine, 2009). Other researchers equally highlight the debate surrounding the need for suitable mechanisms to be implemented in these institutions (for example, El-Hawary *et al.*, 2007; Gambling *et al.*, 1993; Grais & Pellegrini, 2006; Kamla & Rammal, 2013; Karim, 1990a, 1990b; Khan, 2010).

Scholars share the view that the distinctive feature separating conventional and Islamic finance is the latter's strict adherence to the principles and values embedded in religious doctrine (Baele *et al.*, 2014; Beck *et al.*, 2013; Chong & Liu, 2009; El-Bassiouny, 2014; Graafland *et al.*, 2006; Minhat & Dzolkarnaini, 2016; Uddin, 2003). Indeed, the supervision and management of complex religious compliance would require an equally complex and rigorous set of governance structures to ensure that products and operations provided by Islamic financial institutions conform to religious law in order to provide the much needed ethical and societal legitimacy which is expected by stakeholders. Generally, this ecclesiastically driven form of governance can be observed at two separate levels. First, at the organizational level, an IFI should have appropriate internal processes to ensure that religious requirements are fulfilled. Therefore, a key organ of the organizational governance framework is the Sharī'ah Supervisory Board (SSB) which comprises of religious scholars who are responsible for ensuring integrity and credibility of the institution by determining the extent of religious compliance of the bank's operations (Ghayad, 2008; Karim, 1990a, 1990b). Whilst undertaking this governance role, the SSB may, from time to time be required to produce religious rulings or edicts (i.e., fatwa's) by interpreting different legal religious sources. Therefore, the likelihood of generating conflicting opinions exist. It is also fair to add that as the industry expands globally, the likelihood of conflicting religious rules increase, leading to undermining of consumer confidence (Grais & Pellegrini, 2006).

So far there is limited research on the real impact of SSB concentration and how Islamic banks are perceived in the marketplace (Khan, 2010; Weill, 2011). Research on the level of knowledge of Islamic banking concepts and the extent to which the products on offer are 'genuinely' Islamic is also lacking. Since there is no standardized practice of what makes a

product Islamic, there could be a potential gap between what the bank managers, Shari'ah Supervisory Board, regulators and the customers perceive to be truly Islamic financial products. Confounding this is the fact that there are several different opinions on what rules should be applied and what products should be allowed. This problem is likely to persist, as there is no unification of the traditions, rules and practices of Islamic commercial dealings. Additionally, there is less attention paid by scholars to the retail Islamic banking sector, particularly in Western countries such as the UK. Therefore, this study aims to shed important lights on these issues by adopting a qualitative research approach, which is deemed to produce interesting results as new data emerges from the interviewees whom we carefully select based on their role and interaction with the banks offering Islamic financial products (Silverman, 2013).

Advocates of Islamic finance claim that Islamic retail banking has the potential to reach mass-market status (see for instance, Bousama, 2009; El-Hawary *et al.*, 2007; Hayat *et al.*, 2013; Karim & Archer, 2002; Kasri, 2009). However, in the context of the UK, it has still so far failed to do so despite the number of banks increasing. The practical reasons for this underdevelopment are largely unexplained by scholars. Therefore, this study aims to present new evidence as unfolded by bank managers, Shari'ah scholars, regulators and Muslim community representatives on the real obstacles inhibiting the growth of Islamic finance in the UK. Existing literature on Islamic finance is sparse and has also received much less attention to Islamic retail banking in non-Muslim countries such as the UK, which is the subject of this study.

The remainder of this paper is organized as follows: section two provides an in-depth overview of the Islamic finance conceptual framework. The main developments in Islamic finance are discussed in section three. In section four, we provide a discussion on the current modus operandi status of the UK Islamic financial market. Corporate governance and Shari'ah assurance model are discussed in section five. Section six is devoted to research methodology and design. In section seven we present and analyze the interview data. In section eight we discuss the study's main results. Conclusions and future research are presented in section nine.

Islamic Finance Conceptual Framework

The central theme of Islamic banking is the Profit and Loss Sharing (PLS), which prevents the use of interest rate in financial dealings (Iqbal, 1997; Mills & Presley, 1999). Under the PLS model, speculation is forbidden and income must purely be generated from business activities. Islamic finance explicitly forbids the concept of making money on capital without investing the funds in an entrepreneurial business venture (Volk & Pudenko, 2010). Besides, the return generated from investments is not guaranteed beforehand as in some conventional banking products.

Since transactions involving interest and making money out of money at a predetermined rate is forbidden by Shari'ah law, PLS is considered as an alternative to the conventional finance model (Aggarwal & Yousef, 2000; El-Hawary *et al.*, 2007; Jobst, 2007). The PLS model places more emphasis on entrepreneurial activities and the need to share the risk between the parties involved in the financial agreement (Kayed & Hassan, 2011; Rizk, 2008;

Volk & Pudelko, 2010). A summary of the key differences between Islamic and conventional finance principles is presented in Table 1 below:

TABLE 1
Islamic Versus Conventional Finance

Islamic Finance	Conventional Finance
The Islamic finance model follows Sharī‘ah (Islamic law) principles	Conventional finance model follows standard law principles
Financial products and investments used are interest free	Interest rate is applied to products used in conventional finance
Need to conform to profit and loss sharing rules	The main objective is to maximise shareholders wealth
Activities which entail elements of gharar (uncertainty), qimar (gambling), and maysir (game of chance) are prohibited	Investments which entail certain level of uncertainty are allowed
Investments cannot be made in certain products and sectors such as alcohol and tobacco	Most investments can be taken as long as they are profitable
Financial transactions need to be backed by tangible assets	No need for the financial transactions to be backed by tangible assets
Need to pay Zakat (alms giving) on any amount above nisab (property or wealth threshold)	No need to pay zakat

Another important tenet of Islamic banking is making contracts or agreements explicit and ensuring that all financial transactions are backed by real assets (Karim & Archer, 2002; Rizk, 2008). However, this does not mean that Islamic finance prevents making a profit and creating economic wealth. Rather Islamic finance endorses shareholders' wealth maximization alongside the remits of creating social values (Al-Aali & Al-Owaihan, 2013).

Islamic financial institutions are also required to adhere to regulations stipulated by financial regulators and to fully observe the Islamic moral code, the Sharī‘ah (Farook *et al.*, 2011). Furthermore, according to the tenets of Islam, banks have to disclose information on corporate social responsibility and their choice of investments. Attempts have been made to address these issues including creating a uniform system of Islamic corporate governance but it has failed to gain international recognition. Many Islamic financial institutions do not use the Islamic corporate governance framework either because of lack of infrastructure or insufficient human resources, which constitute a fundamental challenge to Islamic finance institutions (Kasri, 2009).

Finally, in order to check the appropriateness of the financial products offered either to retail or wholesale clients, each Islamic financial institution has an in-house board of religious advisers, known as the Sharī‘ah Supervisory Board (SSB) (Grais & Pellegrini, 2006). The

SSB is required to provide an opinion on the products and transactions on whether or not they are compliant with the Shari'ah law. Grais and Pellegrini (2006) point out, however, that there are several issues in relation to their independence. SSB members are paid by the bank and therefore the management of the bank may be tempted to influence them through what is commonly known as "*Shari'ah advisory 'a la carte'*".

Evolution of Modern Islamic Finance

Modern Islamic finance started with the creation of the first Islamic based financial institution in Egypt in 1963, the Mit Ghamr Egypt Savings Association (Chong & Liu, 2009). A few years later the concept of Islamic finance spread to other Muslim countries including Iran, Pakistan and Malaysia. Since then the Islamic finance sector has grown rapidly and is predicted to continue expanding in the future. Islamic banking is now experiencing rapid growth not only in countries with predominantly Muslim populations, but also in countries where Muslims are a minority, such as the UK, the USA and Japan (Boudjellal, 2006; IFSL, 2010).

To date, there are over 500 Islamic financial institutions operating in over 50 countries. Several conventional banks, including HSBC, Citibank, Goldman-Sachs and UBS, have tried to capitalize on this fast-growing segment of the financial services industry by offering Shari'ah-compliant financial products. Despite this impressive growth, many policy-makers, politicians, supervisory authorities and professionals in the finance industry remain very much speculative of the process by which Islamic banks are established into the conventional system (Sole, 2007). The market is at the moment most mature in Malaysia, Iran and the Gulf countries. However, the market is also growing, although at a lower speed, in non-Muslim countries including the UK, which is ranked at the 8th position in terms of the size of reported Shari'ah-compliant assets (IFSL, 2010). The advocates of Islamic finance note that services offered by Islamic financial institutions are not exclusive to Muslims; other customers may be attracted by the ethical standpoint of Islamic finance (e.g. Hayat *et al.*, 2013; Sole, 2007).

Islamic Finance in the United Kingdom

The United Kingdom is the largest market for financial institutions providing Islamic financial solutions in the EU with total assets of \$4.5 billion by the end of 2014 (The City UK, 2015). The first fully fledged Shari'ah-compliant bank in the UK is Islamic Bank of Britain (IBB), which opened in 2004 and was taken over by Masraf Al Ryan and renamed Al Rayan Bank in October 2014. Currently, the UK has the most developed Islamic banking sector in the West with four wholly fledged Islamic banks: Al Rayan Bank; the Bank of London and the Middle East (BLME); Ahli United Bank (AUB); and the European Islamic Investment Bank (EIIB). Al Rayan Bank is the only stand-alone retail bank and has eight branches and more than 50,000 customers across the UK (Al Rayan Bank, 2017). AUB also offers retail banking services like Al Rayan Bank with the main products being Ijara and diminishing Musharaka. Other Islamic banks, which are mainly originated from the Gulf, such as Qatar Islamic Bank and Riyadh Bank offer their products mainly to high net worth individuals and engage mainly in investment banking, private equity and asset management services. A number of major

conventional banks, such as Lloyds TSB, also offer Islamic financial services through Islamic windows (IFSL, 2010; The City UK, 2015).

In addition, there is a wide range of other firms that specialize in Islamic finance services. For instance, the big four audit firms (Price-water-house Coopers, Deloitte, Ernst & Young and KPMG) all provide advisory services in Islamic finance (IFSL, 2010). According to IFSL, London is likely to try to enhance its position further as a gateway to Islamic finance in Western Europe. Supportive financial policies are an important aspect that has helped to broaden the range of Islamic products and services offered to both retail and wholesale customers (Volk & Pudelko, 2010). Establishing a regulatory and fiscal framework for Islamic banks is one of the successful initiatives introduced in the UK. For example, the double taxation on Islamic mortgages has been removed and new arrangements for the issuing of Islamic bonds have been introduced by the regulatory authorities (Belouafi & Chachi, 2014; The City UK, 2015).

Research Methodology and Data

The research process adopted in this study starts with the original research question and then branches out into several sub-questions as informed by the literature review. The main research question that this study is aiming to answer is: What are the main regulatory and non-regulatory challenges facing Islamic retail banking in the UK? This is a broad, complex and constantly evolving issue that entails interrelating themes, both financial and non-financial. We, therefore, decided that qualitative research is the sole methodology able to provide the variety and depth required to fully understand the themes with direct relevance to the research question. It is also ideal for this kind of research since it is possible to observe the area of investigation within its context.

We undertake an in-depth elite interview survey to collect primary data. Many researchers consider this method of interviewing as an effective way to obtain qualitative data (e.g. Harvey, 2011; Lehnert *et al.*, 2016; Salant & Dillman, 1994; Silverman, 2013) and to enable researchers to view the world from the perspective of the informed interviewees (Fink, 1995). It is also effective as it is possible to obtain the opinions and experience surrounding the specific research topic (Collis & Hussey, 2002).

The interviews were semi-structured and were undertaken on a one-to-one basis. Our interviewees include one regulator, one well-known Shari'ah scholar, one senior bank manager and two representatives of the Muslim community in the UK. All interviewees are considered to have extensive knowledge of Islamic finance and hold executive positions in their respective organizations. Table 2 below outlines the interviewees' position and the organizations they represent.

TABLE 2
Study Interviewees Profile

Interviewee	Position Held	Organization
Regulator	Manager of Market Division dealing with Islamic Financial Institutions	Financial Service Authority (now renamed as Financial Conduct Authority)
Banker	Senior Manager	Islamic Bank of Britain (now renamed as Al Rayan Bank)
Sharī‘ah Scholar	Senior Sharī‘ah Scholar	Utrujj Foundation
Representative of Muslim Community	Executive Board Member	Islamic Finance Council
Representative of Muslim Community	Manager	Islamic Finance Council

Interviewees were carefully selected based on their knowledge of Islamic finance and the length of experience they have either in working or dealing with Islamic financial institutions. We also made sure that interviewees do represent all the Islamic finance stakeholders including representatives of the Muslim community, Islamic banks, regulatory authorities and Sharī‘ah scholars. Therefore, we consider the interview data collected to be rich and reflect the different perceptions held over the challenges currently facing retail banking in the UK.

The interview questions are set around the following issues: what is the current Islamic finance situation in the UK; how market participants would like to see Islamic finance in the future and how this could be implemented. Essentially, the purpose of the interviews was to gain inside knowledge of how Islamic banks in the UK are operating and what are the main factors affecting their growth and future prospects, both from the regulatory and non-regulatory standpoints. The full list of interview questions is given in appendix I.

The in-depth interviews were conducted with different participants from five distinct bodies. The market division manager for Islamic institutions at the Financial Conduct Authority (FCA) was the first interviewee. The FCA was chosen to obtain the perceptions from a political, as well as a regulatory perspective. After all, it is the FCA which sets the regulatory playing field and devotes a specialist division that caters to the Islamic financial institutions. The second organization included in this research is the Islamic Finance Council (IFC), which is an independent not-for-profit organization that possesses expertise in both, Islamic law and Islamic economics. An executive board member and a senior manager of the IFC were interviewed and both were senior employees with many years of experience. The fourth interview was conducted with a senior manager from the fully-fledged Islamic bank. The bank manager was chosen to obtain the perspective from an industry expert, which arguably is the most important one in terms of knowledge of where the current Islamic finance challenges

lie. The final interview was conducted with a prominent Shari'ah scholar. Selecting an elite interviewee strategy therefore enabled us to collect rich and reliable sources of data aimed to enrich the findings of the study.

As the interviews were semi-structured, the order of the questions was not strictly followed. The type of questions given to each interviewee was based on his area of expertise and line of responsibility. All the interviews lasted for a minimum of one and a half hours and were recorded and transcribed into a document for further analysis. Notes were taken during the interviews and compared to the transcription to minimize misinterpretations and errors in the collection of data.

We have used open-ended questions to allow the interviewees to elaborate further on the issues covered in the interview questions. Such a research approach is considered appropriate to obtain rich and in-depth data and to access the respondent's own views and interpretations of the themes discussed (see Fink, 1995; Silverman, 2013). This gives the researcher(s) a holistic outlook of the study area.

The principles of interview data analysis stated in Maxwell (1996) were observed in this study. The five interviews were recorded and then transcribed. The interview transcripts were thoroughly read alongside the additional notes taken at the time of the interviews. Then categorization has been applied to the interview data units using the toolkits of the NVivo software. The statements supporting each category are placed together and the rest of the irrelevant data is considered as redundant. Trends and meanings are then sought in the relevant data units based on the participant(s) views of issues discussed with the interviewees.

The cross-analysis carried out on the data enabled us to identify themes from the interview text. These themes have been rearranged to form categories which then formed the bulk of the study results discussion. These categories are: (1) Islamic banking growth and profitability; (2) banking products Shari'ah compliance; (3) effectiveness of Shari'ah compliance model; and (4) factors inhibiting the demand for Islamic banking products. These are fully analyzed in the next section.

RESULTS AND DATA ANALYSIS

Using interview data we examine, thematically, the main factors contributing to the lack of growth of Islamic retail banking in the UK and attempt to identify its current and future regulatory and non-regulatory challenges. The first issue considered in the analysis is the relationship between political factors and the low growth of Islamic finance. Interviewees from the FCA and the Islamic bank agree that the majority of individuals do not consider political factors in their decision to embrace Islamic finance. But the two interviewees from the IFC highlighted that negative publicity by the media about Islam and Muslims in general, and the need to curb terrorist financing had influenced the demand for Islamic finance. For them, whenever there is national reporting of riots or overseas terrorist attacks this had affected the perception of Islamic finance negatively. However, all of our interviewees agreed that there is high support by policy-makers for Islamic finance in the UK through a number of initiatives which were all aimed at creating a level playing field for providers of Islamic financial solutions. This includes removing the double tax on Islamic mortgages, introducing

reforms under which Islamic bond income and return are treated 'as if' interest and the FCA inclusion approach of Islamic finance (The City UK, 2015, p. 9). As a result, we contend that Islamic finance is not subject to political barriers in the UK.

One interviewee from IFC, for example, noted that "In the UK financial authorities have taken many actions to actually encourage Islamic finance. The government continuously supports the development and has tried to create an Islamic hub." The interviewee from the FCA also indicated that in his view there were "no regulatory obstacles for Sharī'ah compliant banks". This is perhaps reflected because Islamic banks like their conventional counterparts are subject to market forces and their financial status mainly depending on the quality of products offered to clients and the magnitude of competitiveness. It is, therefore, fair to state that the underdevelopment of Islamic retail banking is not directly linked either to political events related to Islam, or to deficiencies in the UK financial regulatory framework.

Islamic Retail Banking Lack of Organic Growth

The growth of Islamic finance which is estimated to be between 8 and 15 percent annually as often mentioned in the academic literature is slightly misleading (i.e. Badawy, 2005; Chong & Liu, 2009). It is debatable if this growth is considered to be organic, as the bank customers most likely did not freely choose the Islamic alternative over the conventional one in countries such as Iran and Sudan and do not differentiate between the growth rate of Islamic banks in these countries. Furthermore, the growth rates failed to make distinction between wholesale and retail banking and are provided on a cumulative basis. If the rates are applied to the growth of Islamic retail banking, then they appear to be heavily exaggerated, even with the most modest estimates. This is supported by the IFC interviewee who states that "retail banking growth has been minimal. Certainly, nowhere close to the levels that many people envisaged at the start of the Islamic finance in the UK."

There are three major contributing factors which delineate the poor profitability and growth of Islamic retail banking: (1) the operational costs of the Islamic retail banks, in most cases, are too high; (2) the products on offer are generally more expensive than their conventional alternatives; and (3) the demand for Islamic financial products is growing at a lower rate as many customers still question whether these products are fully Sharī'ah-compliant. A further explanation for the minimal growth is that providers of Islamic retail banking products have not been able to fully take advantage of economies of scale. The IBB interviewee, for example, notes that "the main reason that some of their products are slightly more expensive is that the bank has lesser capacity for economies of scale compared to conventional banks".

Controversial Banking Product's Sharī'ah Compliance

The products currently on offer by Islamic banks or conventional banks with Islamic windows are controversial in terms of their Sharī'ah compliance. Primarily because the mortgage rates, usually referred to as rent by Islamic mortgage providers, are bench-marked against the London-Bank-Offer-Rate (LIBOR), which is an interest rate index. This makes what is claimed to be rent on the mortgage loan effectively an interest rate. Banks purposefully do this in order to minimize the financial risk exposure of their liabilities. This is one of

the major issues where Islamic retail banks fail to adhere to Islamic values and hence raise concern about their credibility. As noted in section two, Islamic banks are assumed to be using interest-free products in order to comply with Sharī'ah principles (Chong & Liu, 2009). The bank interviewees states that "LIBOR is only a benchmark and it does not make the product *halāl* (permissible) or haram (non-permissible)... it is a way to price our products. Sharī'ah scholars have approved this for the time being because Islamic banking is a very young industry". The Sharī'ah scholar on the other hand notes that "the use of LIBOR does not invalidate the product and the transaction is ineffective without the use of the benchmark. Although using LIBOR is not ideal but has practical relevance and serves the actual purpose of setting the rates on Islamic loans". However, we maintain that since some of the loan payments, such as mortgages, are made over a long period for which the price of the property will differ and thus, the rent should actually be based on the average rent paid by similar properties in the local area where the property is located and not based on LIBOR. What is evident, however, is that the rent varies considerably from one region to another and this is unlike LIBOR. Therefore, perhaps establishing a new benchmark which is fully religiously compliant is essential to enhance confidence and provide further reassurance among the users of Islamic financial products.

Furthermore, the current practice of Islamic mortgage providers, in case that the home buyer defaults on his loan, is not to take almost all of the losses, which again is, arguably, against Sharī'ah law. Based on Islamic precepts, both profit and losses are expected to be shared between the mortgage recipient and the bank based on their homeownership rate. This is considered imperative by the IFC respondents and one interviewee states that "non-interest financing and profit and loss sharing mechanisms are at the centre of Islamic financial contracts and should always be observed by Islamic banks".

In addition, some of the Islamic banks keep interest-bearing securities on their balance sheets, while at the same time their staff informs clients that they do not earn interest on their investments. The bank manager, surprisingly, notes that this is mainly due to the low level of knowledge of some bank staff about Islamic finance. Therefore, they are not able to explain appropriately how the products are structured, and thus, on a number of occasions customers walk out disappointed as a result of this. However, the bank is doing its best to improve its relationship with the clients and reduce the level of confusion caused by a lack of clarity over the products sold.

Weaknesses in the Sharī'ah Assurance Model

The process of ensuring that the products are Sharī'ah-compliant is undertaken by scholars who are supposed to have extensive knowledge of Islamic commercial jurisprudence and serve as guardians of Islamic finance (Ginena, 2014). All of our interviewees emphasized that in order to assess the compatibility of Islamic banking products to Islamic values while ensuring that the product is also competitive towards other conventional products on offer in the market, scholars need to have an extensive understanding of the entire banking system, both Islamic and conventional. Currently, the certification process is carried out either by an individual scholar or group of scholars via the Sharī'ah supervisory board. The Sharī'ah

scholar notes that "there are different levels of certification and it is the law firms, which prepare the whole documentation for the new products and the role of the SSB is to review the documents and ensure that the product structures and features fully comply with Sharī'ah rules". Recommendations are then made taking into account the local jurisdictions as well as tax legislations. In terms of the day to day transactions, the internal Sharī'ah advisor submits a report to the SSB based on a sample, which is approximately between 20 to 30 percent of the transactions reviewed. This means that there is an inherent risk that the sample may not fully represent the whole transactions carried out by the bank. This gives rise to a conflict of interest between the bank and its shareholders and savers. It also raises major concern on the credibility of the Sharī'ah assurance report issued in Islamic banks' annual reports. There is also a risk that the bank may change the product after the approval from the scholar(s) in order to accommodate the market needs. If this happens, it is a problem, but this is no longer a matter of concern for the scholar(s) or the Sharī'ah board rather it is an issue for the bank board of directors.

In essence, there is no clear view of the extent of scholars' involvement in the design as well as giving an independent opinion on product compliance. Consider, for example, a bank developing a new Sharī'ah-compliant product. Before the product is added to the bank portfolio it needs to ask the scholar(s) whether it is permissible or not. In the first instance, the scholar does not agree. The bank then goes back and re-designs the product and asks the scholar again, who still says it is not compliant. In the second instance, the bank asks the scholar for advice on how to make the product permissible. The scholar gives advice on how to structure the product to be Sharī'ah-compliant. In this instance, the scholar is moving from the process of certifying into designing, which is not in line with the expected role of the scholar(s). However, the Sharī'ah scholar has a different opinion on this and states that "IFSB standards are observed in the issue of fatwa (Islamic ruling) when new products are launched by the bank(s) and scholars act independently in outlining their opinions without the influence of bank managers".

The scholars are also involved indirectly in providing assurance to bank managers over the credibility of their products. This is mainly attributed to the lack of Islamic finance knowledge amongst the bank staff and also having a very limited number of qualified scholars. The top ten scholars represent almost 40% of all Sharī'ah supervisory boards in the world. Intriguingly, if the top 100 scholars are taken into account, they represent almost 84% of the boards. The scholars essentially set the standards at which they consider the product(s) to be Sharī'ah-compliant for the whole industry. Currently, there are no specific regulations for the tasks undertaken by the scholars, which theoretically mean that they are free to give the same views, simultaneously, on the design to different institutions offering the product(s). Further, taking into consideration that some of the scholars sit on 85 supervisory boards, it is debatable how they can certify all the products effectively. The Sharī'ah scholar, however, has a different view of this issue and notes that "the SSB also uses a secret/undercover individual who makes a number of visits to the bank to check the way they conduct their business and if their transactions adhere to Islamic values". The random visits by the secret individual enable the Sharī'ah board to find if there are any irregularities in the lending policies of the bank

and ensure continuous monitoring of the bank activities. Another challenge facing the SSB is 'scholar inter-locking' (i.e., having the same scholars on different institutions' Shari'ah boards), which creates a lack of proper conduct as well as lack of independence.

According to the Shari'ah scholar interviewed, this is a continuous accusation, which was suggested to be unproven as law firms operate on the same basis as the SSB. Our interviewee also remarked that scholars sign confidentiality agreements and scholars rarely hold shares in these banks, and if they do, their shareholding is only limited. In addition, scholars have no bias, in any form, towards the banks as they have religious responsibility and accountability. However, from a strategic and financial point of view, having the same scholars on different boards undermines banking competition and overall credibility. Therefore, there should be a limit for the number of boards that an individual scholar may serve. Another solution to this problem is to adopt the Malaysian banking model in which the Shari'ah Advisory Council takes full responsibility of Islamic banks Shari'ah related matters (Bank Negara Malaysia, 2016). However, this is likely to be less suitable in markets that are dominated by conventional banks like the UK.

Lack of Trustworthiness in the Islamic Retail Banking Products

Another problem facing Islamic banks is that only a small number of customers have embraced the idea of Islamic finance. The Shari'ah scholar attributes the cause of this problem to two main reasons: (1) many Muslims are mainly concerned with the price of the product and at the moment the rates offered by conventional banks are far better than their Islamic counterparts; and (2) there is lack of understanding and education, particularly by imams (mosque leaders) as most individuals are likely to ask them about the permissibility of current Islamic financial products before even approaching the bank. Therefore, it is imperative that imams are educated on modern financial dealings to avoid negativity leading to an adverse reputation for Islamic banks. The scholar participating in our research also admitted that some mistakes are made but the overall experience of Islamic banking is still satisfactory.

On financial grounds, Islamic retail banking in the UK has not been a viable proposition to individuals. The target market is not big enough to be able to compete on the price of comparable conventional banking products. About 4.8% of the UK population is considered Muslim, which is already a relatively small market. Within this population, three categories of Muslims are generally observed. The first category is those Muslims who do not follow Shari'ah rules in general and Islamic finance in particular. They are satisfied with conventional finance and they would only consider Islamic financial products if they were given a competitive offer. The second category of Muslims prefers Islamic banking but do not believe that current products on offer are truly Islamic and do not see a distinction between conventional and Islamic products. According to our analyses of the interview data, this is the largest group amongst the three categories. The third category is those Muslims who agree that the current products offered by Islamic banks or conventional banks with Islamic windows are truly Islamic. However, when the first and second categories are taken away from the market, it has proven that the potential market for Islamic financial products remains very small suggesting that the industry has failed to attract the second category of Muslims.

Another inherently problematic issue is to consider the 2.7 million Muslims living in the UK as one cohesive group. This group of people is highly heterogeneous, in the sense that they are coming from a range of historically, linguistically, geographically and culturally different backgrounds. Muslims in Britain emanate from Africa, the Middle East, South Asia, South East Asia and even Europe. They are from both Shia and Sunni religious sects and they even belong to different schools of law within the same sects. There are four main schools within Sunni jurisprudence (Hanafi, Maliki, Shafi'I & Hanbali), and two within the Shia sect (Jaafari and Zaidi) and two other separate schools (Ibadi and Zahiri). These schools have different perceptions about Islam and subsequently Islamic banking making any notion of collective standardization and uniformity of practice exceptionally difficult.

Discussion and Implications

The study reveals that Islamic retail banking in the UK is growing at a lower rate than anticipated. This is mainly attributed to the approach taken by Islamic banks in imitating conventional banks in pricing their products including the use of LIBOR as a benchmark to set their saving rates and lack of Islamic finance knowledge among the Muslim community, which leads to the demand for Islamic banking services to be minimal. Although this is mainly supported by the representatives of the Muslim community rather than the Sharī'ah scholar and Islamic bank respondents particularly on the viability of the Islamic banks products as authentic Sharī'ah-compliant products. One can deduce this variation in opinion to the interest of each party in the business functions of Islamic banks. While Islamic banks and their Sharī'ah board are highly influenced by what they see as the only way to conduct the bank's business activities, the Muslim community perceives the religious authenticity of the products under offer as the main determinant of choosing an Islamic bank over a conventional one.

In terms of the regulatory environment, we find that the UK financial authorities to be highly supportive of the growth of Islamic retail banks by creating a decent playing field for their activities. Islamic banks, however, like their conventional counterparts are subject to market forces and it is in this capacity that we believe Islamic banks fall short. For example, the current rates of Islamic banks' loans and mortgages are considered to be more expensive than those offered by many conventional banks. There is also a lack of choice in the products under offer and some of them are not suitable for certain forms of financing and entail a high level of credit and operational risks. A number of flaws are found in the way the SSB plays its role in ensuring that the Islamic bank is compatible with Sharī'ah rules. Most scholars tend to sit on the Sharī'ah board of different banks which raises concerns on how the interests of the shareholders and savers are protected. A number of scholars also seem to lack finance and banking knowledge as they come from the Islamic law (*fiqh*) background.

The Sharī'ah scholar and the bank management, nonetheless, stress that the SSB acts independently and tentative checking is carried out on all product documentation before being approved. Adjustments are only made when there is a contradiction with tax rules and some of the jurisdictions of the country where the bank operates (i.e. the UK). This means that the products are mainly judged on the basis of law compliance rather than if they are

religiously permissible as pure Islamic financial contracts. In the light of the concerns related to the products' religious authenticity, we recommend that future research addresses the issue of risks involved when scholars undertake the review of the Islamic banking product(s). Researchers could also investigate how purely Islamic financial products can be created under the new regulatory and social environment in which banks operate and how to reach more clients, either Muslims or non-Muslims, who may have an interest in investing in Islamic financial products.

Since the process of Sharī'ah assurance is dynamic, this further increases the need for transparency and openness. In particular, industry practitioners should consider the following: (i) disclose information on the interest of scholars in the institution, such as shareholdings and notes on the meetings with the board of directors; and (ii) disclose the parameters, both financial and non-financial, under which the scholars have allowed the product(s).

Conclusions

The findings presented in this study show that policy-makers and regulators in the UK have so far taken many actions to encourage Islamic finance. In fact, there appear to be no political or regulatory obstacles facing the providers of Islamic financial solutions, and most of the challenges facing Islamic banks or conventional banks with Islamic windows are purely market-driven or social. However, this did not prevent major conventional banks in the UK from scaling down their Islamic retail operations. The growth of the industry has also been minimal and the profits have not materialized, even during extremely favourable times.

Our study reports that only a small number of individuals have so far embraced the idea of Islamic finance in the UK. The Islamic products currently available are considerably more expensive in comparison to their conventional counterparts, and it is, therefore, plausible to suggest that this is most likely to be a reason for this low intake of these products by individuals. Islamic banks also incur heavy additional expenses, such as the remuneration and fees paid to Sharī'ah scholars, and this is among the main contributing factors to the increased cost of Islamic products.

Another challenge facing Islamic retail banking is the characteristics and measuring tools used for the products under offer, which are considered non Sharī'ah-compliant by many scholars. Applying Sharī'ah standards to these products makes them not truly Islamic, but the banks still markets them as if they are genuinely Islamic. This is ultimately a question of corporate governance and transparency.

This study also alludes to the fact that the current model of Sharī'ah assurance is debatable; we find that it is subject to extensive criticism and fails to address current market needs. Regrettably, Islamic banks are currently very dependent on a small number of religious scholars. It is also questionable how they can effectively certify such a vast number of products from different regions and systems from across the world. Besides, the current Sharī'ah assurance model, as it is applied, is dynamic, which effectively means that scholars can allow for "semi-Islamic" products to be called Islamic and it is likely that these conditions are not fully disclosed to their customers. Finally, the Sharī'ah scholar(s) indirect involvement in the product design undermines his credibility as an external assessor.

Islamic banks face further problems caused by the low level of knowledge about Islamic finance by imams and the Muslim community who in many cases are unable to distinguish between conventional and Islamic finance. This is exacerbated by banks' employees who themselves sometimes not properly explaining the structure of the products they offer to their clients. With a Muslim population of around 2.7 million, the banks are also targeting only a very small segment of the UK financial market. What makes the promotion of their products even harder is that the Muslim population in the UK is highly heterogeneous with diverse backgrounds and hence have different perceptions of Islamic finance. Therefore, the target market might not be large enough to be economically viable to both Islamic banks and conventional banks with Islamic windows unless the existing products attract non-Muslim clients.

In terms of research limitations and while the number of interviews conducted is small, our study participants have a lengthy experience in their field and their knowledge of Islamic banking is extensive. The interviewees also hold senior positions in their respective roles and they are directly involved in the decision-making and leadership of the area(s) they are responsible for including bank day-to-day management, regulation, Shari'ah compliance, and representation of the Muslim community. Therefore, their views encapsulate the actual perceptions held over the challenges currently facing retail banking in the UK as a whole.

In general, the evidence presented in this paper, based on the elite interview data and supported by the relevant literature enabled the researcher(s) to answer the research questions set. The seniority of our interview participants and offering them the opportunity to branch out through open-ended questions has resulted in detailed and rigour answers to these questions. Therefore, the study findings are considered to be robust and truly reflect the current state of Islamic retail banking in the UK in terms of its regulations, Shari'ah compliance, and other challenges facing the sector.

1 Appendix: List of Interview Questions

Interviewee	Interview Questions
Regulator	<p>Q 1. What is your perception of the effect of political factors or decisions on Islamic banks?</p> <p>Q 2. What do you think are the reasons behind the lack of growth in Islamic banks?</p> <p>Q 3. How regulators are currently supporting the growth of Islamic banks in the UK?</p> <p>Q 4. What are the main regulatory challenges currently facing Islamic banks in the UK?</p>
Banker	<p>Q 1. What do you think are the main reasons of lack of growth and poor profitability in the bank?</p> <p>Q 2. Do you think that the current method of pricing the bank products is a contributing factor to the low demand for its products?</p> <p>Q 3. How the bank is ensuring that the products are compliant to Islamic rules?</p> <p>Q 4. What do you think are the main problems of the current Sharī'ah assurance model currently adopted in the bank?</p> <p>Q 5. Do you think that having the same scholars on the Sharī'ah board of different banks is having an effect on the credibility of the bank products?</p>
Sharī'ah Scholar	<p>Q 1. How scholars ensure that the bank is fully compliant with Sharī'ah principles?</p> <p>Q 2. What is the current approach followed by scholars in the certification process of the bank products?</p> <p>Q 3. Do you think that the current approach followed in pricing Islamic products is <i>ḥalāl</i> (permissible)?</p> <p>Q 4. Do you think that scholars are indirectly involved in the design of the bank products?</p> <p>Q 5. Do you think that having the same scholars on the Sharī'ah board of different banks is having an effect on the credibility of the bank products?</p>
Representatives of Muslim Community	<p>Q 1. What do you think are the main factors taken by Muslims when buying banking products?</p> <p>Q 2. What is your perception of the effect of political factors on the image of Islamic banks?</p> <p>Q 3. What do you think are the main reasons for the unpopularity of the current Islamic banking products on offer?</p> <p>Q 4. What do you think is the current knowledge of Muslims of retail Islamic banking products and services?</p> <p>Q 5. What do you think are the main issues and concerns Muslims do have in relation to the Sharī'ah supervisory board role and Sharī'ah compliance as currently practiced in Islamic banks?</p>

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