

The Development of Islamic Banking and Finance. Underpinning Theory Affecting Islamic Banking Consumers Post Purchase Behaviour¹.

Nuradli Ridzwan Shah Mohd Dali^{a2}, Shumaila Yousafzai^b and Hanifah Abdul Hamid^c

^a*Faculty of Economics and Muamalat, University Sains Islam Malaysia*

Email: nuradli@usim.edu.my

^b*Cardiff Business School, Cardiff University*

Email: yousafzais@cardiff.ac.uk

^c*Faculty of Science and Technology, University Sains Islam Malaysia*

Email: hanifah@usim.edu.my

Abstract

The aims of this paper are twofold that are to provide an introduction to Islamic banking and finance (IBF) and its current development in Malaysia. This paper is a theoretical paper discussing the origin of the establishment of Islamic banking and finance, the interaction between Islamic economics and *muamalah*, some historical background and the current development of Islamic banking and finance in Malaysia. This paper exposes the growth trend in Islamic banking and finance is inevitable and how the research focus is now should be shifted towards the marketing aspects of the IBF system.

Keywords: Islamic banking and finance, Islamic banking, Islamic economics.

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² The author is also attached as a research associate at Asean Research Centre for Drug Abuse (ACREDA) and attached as a research fellow at Islamic Finance and Wealth Management Institute (IFWMI).

1.0 Introduction

This is a theoretical study exploring the development of Islamic banking and finance industry in the context of Malaysia. The major contributions of this paper can be attributed to the new knowledge of the existing conventional theory in the IBF industry advocating that a new model should be introduced to cater the uniqueness of the IBF system. It builds from religious obligations of the Muslims as a whole but with a specific context of Malaysian IBF system. The uniqueness of Malaysian banking system which runs on a parallel banking system, allows the Islamic banking (designed to meet the needs of the Muslims) and conventional banking (assimilating the western banking) to compete and operate side by side. Theoretically, conventional theory maximises profit. Logically, the theory can be accepted if the underpinning theory of IBF are of the same as the conventional theory. However, many studies have shown that the selection (pre-purchase), usage (consumption) and customer's satisfaction (post-purchase) of IBF users are religiously motivated. However, there are also studies that argue that the Islamic banking users are profit motivated merely the same as the conventional banking users. Building from previous theory, this paper aims to explore the origin of IBF and its underpinning theory. Specifically, this study discusses conceptually the IBF system. Findings from the study revealed that the alternative theory of Islamic economics requires a re-modification or an invention of a new model for IBF system should be developed. This paper is organised into seven sections with the objective to introduce the Islamic banking and finance in Malaysia. The next section will discuss about the origin of Islamic banking and finance. The following section explains the interaction between economics and *muamalah*³. The historical development of IBF were also discussed taking the global and Malaysian perspectives into the picture. The discussion on underpinning theory of the IBF system is also presented to give an overview on how the system is different from the conventional theory. In addition, a discussion on whether the IBF has diverged from its ideal state or theory is also presented. Lastly, this study suggests that taking consideration religious motives as one of the major factors contributing to the existence of IBF, a re-modification or an invention of new models should be developed to cater the uniqueness of IBF system. Specifically, this study advocates future research on post-

³ The divine revelation regarding relationships between human with God, human with human and human with environment.

purchase behavioural studies to be conducted to fulfil the gap between theory and practice.

2.0 The Origin of Islamic Banking and Finance

The word Islam means "full submission", or the total surrender of oneself to God (Arabic: الله, Allāh) and releasing oneself from worshipping other than Allah⁴. An adherent of Islam is known as a Muslim, meaning "one who submits to Allah" (Diffen contributors, 2013). There are approximately 1.6 billion Muslims in 2010, making Islam the second-largest religion in the world, after Christianity (Pew Research Center's Forum on Religion and Public Life, 2012). According to the *Qur'an*⁵ and *hadith*⁶ all Muslims have to believe in God, his revelations, his angels, his messengers, and in the "Day of Judgment". Islam is *Ad-Din* that is a religion or a way of life that governs humankind. *Ad-Din* is universal that comprise every aspect of human life including *Shari'ah*⁷, *akhlaq*⁸ and *aqidah*⁹. The *Shari'ah* law can be divided into two categories which are *ibadah* and *al-muamalah*.

Ibadah is the acts of worships to Allah swt while *al-muamalah* dealings are the interactions between one to another human. While *ibadah* focus on the 5 pillars of Islam, *al-muamalah* law is covers all human interactions such as *siasi* (politics), *iktisod* (economics), *muamalat* (business), *munakahat* (marriage), social and *jinayat* (crime). The rules and the degree of compliance based on *fiqh muamalat*¹⁰ are as the same as other functional Islamic rules. It is consider as an *ibadah* and is given rewards as long it complies to the pillars, rules and sincere to get blessings from Allah swt. Islamic finance falls under the *al-muamalat* category as mentioned above. Islamic banking and finance is shown in the following figure.

⁴ See Quran Surah Al-Imran, verse 64, Surah Al-Zukhruf, verses 26-28, Surah Al-Bayyinah, verse 5 and Hadith Sahih Muslim No 8.

⁵ The holy book of the Islam

⁶ The sayings and actions of the Prophet Muhammad along with the *Qur'an*; these form the core of Islamic law (*fiqh*), the earthly representation of the *Shari'ah* (Divine Path) that all Muslims must follow.

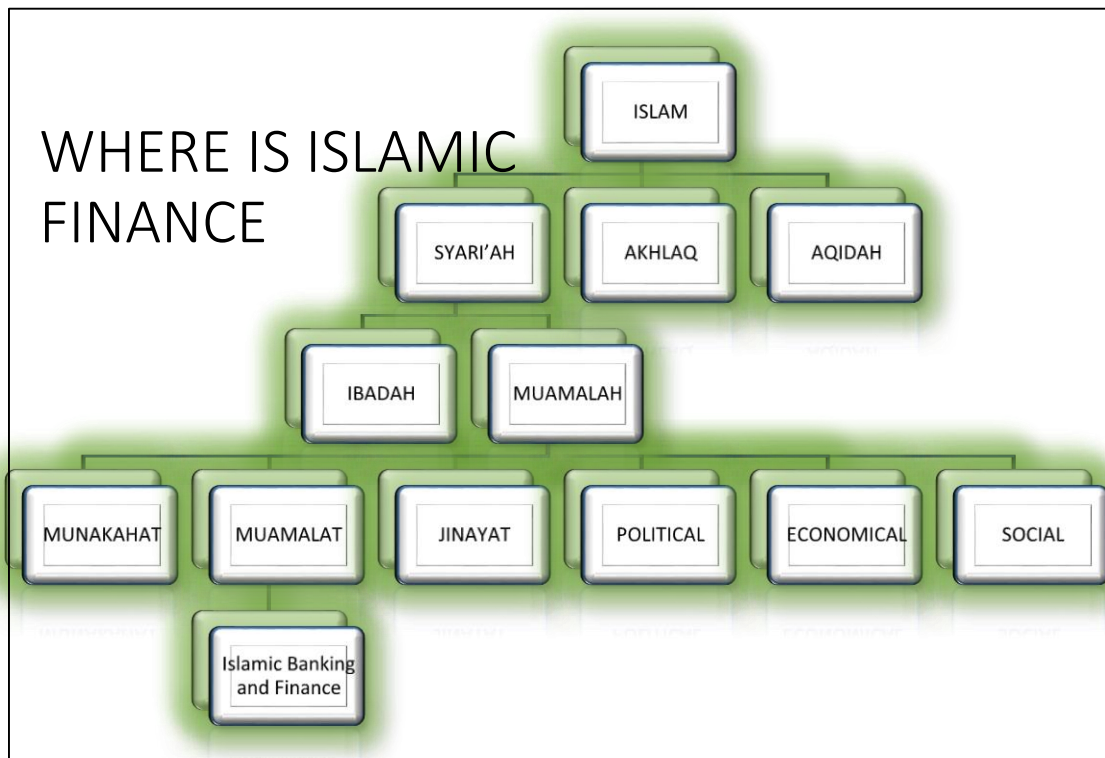
⁷ Islamic canonical law based on the teachings of the *Al-Quran* and the traditions of the Prophet Muhammad p.b.u.h. (*Hadith* and *Sunnah*), prescribing both religious and secular duties and sometimes retributive penalties for law breaking.

⁸ Good manners

⁹ *Aqidah* (عقيدة) is an Islamic term meaning creed. Deep believe on the teachings and laws (hakam) of Allah

¹⁰ Islamic jurisprudence on business transactions

Figure 1: Islamic Banking and Finance Position in Islam



Source adapted from Mohd Dali et al. (2008).

The figure above shows that Islamic banking and finance is not separated from Islam and is an integrated part of Islam. As mentioned earlier that an adherent to Islam is Muslim, therefore religiously, a Muslim should embrace Islamic banking and finance.

3.0 The Interaction between Economics and *Muamalah*

Islam has a complete, progressive, and dynamic economic system made up of systematically regulated production activities, although it imposes a concurrent responsibility towards a social welfare of the community (Mohd Dali et al., 2008). Islamic economic system may be conceived as comprising three sectors: *siasi* sector (public sector), *tijari* sector (private sector), and *ijtima'i* sector (social welfare sector). The recognition of the last sector in the organization of economic activities of a society is unique to Islam. As shown in Table 1, each of the three sectors has its own specific functions, possible forms of institutions, and sets of *Shari'ah* laws to abide by and

implement. While there might necessarily be some measure of duplication between and among the three sectors, their lines of demarcation are nonetheless clear and well-defined. In the scheme of organisation of the Islamic economic system, the *tijari* sector (private sector) is really the main centre of economic activities and the engine of economic production and growth. It is mainly here the value-added is produced and wealth is created. The Islamic banking and finance falls into this sector as a business entity.

Table 1: Sectors in Islamic Economic System

SYSTEM	ISLAMIC ECONOMIC SYSTEM		
SECTOR	SIASI SECTOR (Public Sector)	TIJARI SECTOR (Private Sector)	IJTIMAI SECTOR (Social Welfare System)
SOME MAJOR FUNCTIONS	<ul style="list-style-type: none"> • Maintenance of law, order, justice and defense. • Promulgation and implementation of economic policies. • Management of properties under State ownership. • Economic intervention as necessary. 	<ul style="list-style-type: none"> • Creation of wealth (Economic activities of production and consumption and distribution) 	<ul style="list-style-type: none"> • Islamic Social Security (<i>al-Takaful al-Ijtimai</i>)
POSSIBLE INSTITUTIONS	<ul style="list-style-type: none"> • Government Ministries and Departments • Statutory Bodies • Government Companies 	<ul style="list-style-type: none"> • Owner-operator • <i>Sharikah</i> (partnership, join-stock company and co-operative society) 	<ul style="list-style-type: none"> • Public-Sector Entities: <ul style="list-style-type: none"> * <i>Bait at-Mal</i> * <i>Bait al-Zakah</i> • Private-Sector Entities: <ul style="list-style-type: none"> * Charitable Organisations * Individuals
SOME RELEVANT SHARI'AH LAWS	<ul style="list-style-type: none"> • Various Government Administration Laws: <ul style="list-style-type: none"> * Company Laws * Commercial Laws * Land Laws * Mining Laws 	<ul style="list-style-type: none"> • Various <i>Fiqh al-Mu'amalat</i> Laws: <ul style="list-style-type: none"> * <i>al-Mudharabah</i> * <i>al-Musharakah</i> * <i>al-Bal'</i> 	<ul style="list-style-type: none"> • Various <i>Ijtima'i</i> Laws: <ul style="list-style-type: none"> * <i>al-Zakah</i> * <i>al-Waqf</i> * <i>al-Tarikah</i> * <i>al-Sadaqah</i>

	* Taxation Laws	* <i>al-Bal' Bithaman Ajil</i> * <i>al-Ijarah</i> * <i>al-Rahn</i> * <i>al-Kafalah</i>	* <i>al-Qardz al-Hasan</i>
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Source adapted from Mohd Dali et al. (2008)

The above table shows that revealed that there are three major components of Islamic economics and IBF falls into the private sector (*tijari*). Therefore, there is an interaction between Islamic economics and IBF. Conceptually, IBF is not confined to *Shari'ah* laws and regulations only but also is moulded according to the theories and principles of Islamic economics. As mentioned earlier, IBF consists of the three sectors, its development individual sectors are encouraging in Malaysia and globally. For instance, the *ijtimai* sector has seen the growth in the *waqf* and *zakah* and the insitutionalisation of managing these types of funds. The public sector (*siasi*) in Malaysia has provide full infrastructural support in terms of its legal and operationalisation of IBF required laws. In the private sector, Islamic banking, Islamic stock markets, *sukuk* and *takaful* industries are growing at a tremendous rate. However, the biggest compositions of the assets of the private sector comes from Islamic banking. Therefore, this paper will focus on Islamic banking and some historical and development in the global and Malaysian market will be discussed in the following section.

4.0 Historical Development of Islamic Banking

The first IB savings bank was established in 1963 as the Mit-Ghamr Islamic Savings Bank (MGISB)¹¹ in Egypt¹² (Solomon, 1996). It was tremendously popular and initially prospered (DiVanna, 2006; Kahf, 1999) but was closed down in 1967 due to political pressure from the Egyptian social authorities (Chachi, 2005; Zainol, Shaari, & Muhammad Ali, 2008). In 1971, MGISB re-emerged as Nasser Social Bank. It provides services to assist small and medium industries and educational finance for students who are financially disadvantaged (DiVanna, 2006; Zainol et al., 2008). In 1975, a group of Muslim businessmen set up a private Islamic bank named the Dubai Islamic Bank. Later

¹¹ The bank was set up by an economist, Dr. Ahmad Elnaggar.

¹² A detailed history of the establishment of IB is given in Chachi (2005).

in 1977, the Faisal Islamic Bank was set up in Egypt and Sudan, and Kuwait Finance House was set up in Kuwait.

As for Malaysia, the earliest Islamic fund management company was established in 1962. It was initiated by the Malaysian government and the organisation was named “Pilgrim’s Management Fund” or “Lembaga Tabung Haji” (Haque, 2010; Kuo, 2009). The main aim of the establishment was to assist prospective pilgrims to save money and at the same time to make a profit from investment on their behalf. Tabung Haji is not considered an Islamic bank since it does not provide loans to the public. Nevertheless, it led to the establishment of the first Malaysian IB in 1983, namely Bank Islam. The IB system evolves to become an important Malaysian financial system offering banking products.

4.1 Islamic Banking Globally

The global IB sector is growing at a tremendous rate. IBF can be categorised to four major assets classes. They were Islamic banking (USD1.1 trillion as at end 2011), *sukuk*¹³ (USD178.2 billion as at end 2011), *takaful*¹⁴ (USD15.2 billion as at end 2011) and Islamic funds (USD60 billion as at end 2011) (World Bank. Development Data Group, 2012). The growth of IB further demonstrates its increasing financial power and its importance to Muslims worldwide. This is also shown in the broadening geographical customer base of IB, which is moving beyond its historical boundaries. For instance, IB is expanding from countries such as Malaysia, Iran and the Gulf Co-operation Council (GCC)¹⁵, into the Middle East, North Africa,¹⁶ Asia,¹⁷ the USA and Europe (McKenzie, 2010).¹⁸ Table 2 presents the global geographic distribution of Islamic banks.

¹³ Similar characteristics to that of a conventional bond, but it is asset backed.

¹⁴ A scheme of mutual support, which offers insurance to people against the dangers of falling into unexpected and dire need.

¹⁵ GCC comprises of six countries such as Oman, Kuwait, Bahrain, Qatar, UAE and Saudi Arabia.

¹⁶ e.g. Jordan, Egypt, Turkey, Sudan, and Syria.

¹⁷ e.g. Singapore, Indonesia, Hong Kong, Pakistan, Bangladesh and China.

¹⁸ e.g. France, Germany and the United Kingdom.

Table 2: Global Distribution of Islamic Banks

Europe	North America	South America	Asia	Africa
Turkey (1), UK (6)	USA (4)	None	Pakistan (6), Bangladesh (3), Bahrain (9), Iran (14), Jordan (2), Kuwait (2), Lebanon (1), Qatar (3), Saudi Arabia (6), UAE (4), Brunei (3), Philippines (1), Malaysia(17), Thailand (4)	Algeria (1), Gambia (1), South Africa (1), Sudan (4)

Compiled from various sources from
<http://www.openoffshorebankaccountsfornonresidents.com/ListIslamicBanks.htm>

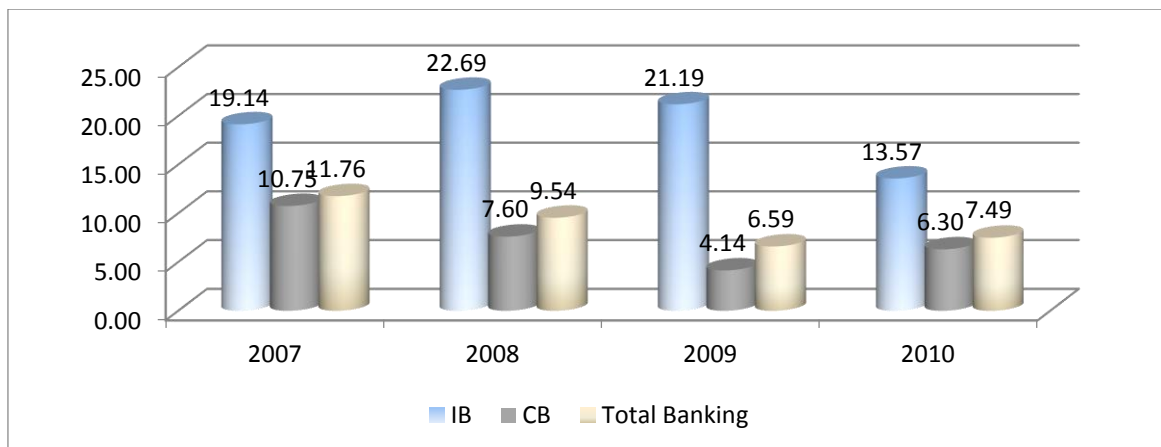
Despite the creation of Islamic banks in many different locations around the world, they remain mostly concentrated in Asian countries or in developing countries where the majority of the country's population are Muslims. IB is also getting attention from none majority Muslims countries. For example Thailand has four institutions offering Islamic banking products (Haron & Yamirudeng, 2003). Currently, there are over 300 Islamic banks worldwide, spread across 75 countries. Inevitably, financial and academic circles in the 21st century cannot afford to ignore the globally crucial role that the IB industry plays. Growing globally, IB sector is a critical element of the Malaysian financial system. Moreover, it contributes greatly to Malaysian economic development and growth.

4.2 The IBF Development in Malaysia

Financial innovation and growth in Malaysia is unique because it is motivated by religious factors (Kuo, 2009; Warde, 2000). IB has evolved in stages starting from the first Islamic bank establishment in 1983 (Bank Islam (M) Berhad) which was then followed by the second fully-fledged Islamic bank, Bank Muamalat, in 1999. Ten years (1993) after the establishment of Bank Islam, the central bank of Malaysia agreed to authorise conventional banks to offer Islamic windows. This has given the privilege to the conventional banks to offer Islamic banking products to their Muslim customers. The IB Scheme (IBS) then replaced the Islamic windows in December 1998. Initially, the IBS is offered by conventional banks which are operated by the low hierarchy IB Department (IBD) (Rosly & Abu Bakar, 2003). In 2005, Bank Negara Malaysia approved the

conventional banks to form seven Islamic subsidiaries (IS). The growth of Malaysian IB structures was supported by the introduction of the IB Act 1983, which regulated the operations of Islamic banks in Malaysia. With strong support from the Malaysian government, relentless IB product innovation, and a comprehensive financial infrastructure, more Islamic financial institutions have since been established. Currently, Malaysia's IB continues to grow rapidly, supported by the positive Malaysian economic environment.

Figure 2: IB Assets' in Comparison to CB and Total Banking Assets' Growth Rate in Malaysia (2007 to 2010)



Source: (Bank_Negara_Malaysia, 2007, 2008, 2009, 2010)

Figure 2 proves that Malaysian IB assets' growth rates for year 2007 until November 2010 indicate better performance than conventional banks (CB) and overall banking assets' growth rates. The evidence reflects the importance of IB in the Malaysian economic development. In addition, the government of Malaysia has encouraged IBs to capture around 20% of the total market share of loans and deposits by 2010 (Dusuki and Abdullah, 2007). Despite on its importance and growth potentials, can we use the existing theories and measurement models for Islamic banking and Islamic economics as whole? Any measurement models should measure what it is supposed to measure either from the perspectives of the economy, industries, companies or customers. It should be based from

a theoretical lenses that will guide the development of the measurement models. Therefore, the next section, will introduce the underpinning theory that forms through Islamic economics. Specifically, this study focusses on the post purchase behavioural of Islamic banks consumers or customer satisfaction. This is because the post behavioural studies from the consumers demand in the context are more complicated as compared to the firms' supply side.

5.0 Alternative Theory from a Different Perspective

Unlike conventional theories, the Islamic perspective offers a different point of view. Both modern and traditional Islamic theories of economics were put forward challenging the existing capitalist theories such as the theory of rationality, profit maximisation and others (Chapra 1974, 2000). Not only Islamic theorists, but Fornell (2007), the founder of ACSI, went against traditional economic theory of firms, productivity, economic assets and sellers' power because the modern economy shifts according to the relationships/alliances of customers' demand and investors' capital movements. The major differences between conventional and Islamic economics are rooted in their theoretical foundations and principles. The Islamic economics puts much consideration onto spiritual aspects whereas conventional economic systems mainly acknowledge monetary or material rationality. Even though there are advocates of non-materialism in conventional economics, they tend to be marginalised. Hence, the objective of conventional economics is profit maximisation while the objective of Islamic economics is *falah*¹⁹ maximisation (Arif 1985) and for that reason, profit for a company or cost for the consumer might be lower or higher in the Islamic economic system in comparison to the conventional economic system. This is because the time horizon for conventional economics is limited to one's lifetime while the Islamic economic time frame goes beyond into the afterlife in which sometimes costs can be insignificant for the participants/consumers in the Islamic conception of economics (Mersha 1992). As a consequence, a Muslim consumer is considered as irrational in a rational market according to conventional economic theory (Kartajaya and Sula 2006). Instead, they argue that the Muslims are a part of an emotional market because their consumption patterns are not solely motivated by profit or cost motives.

¹⁹ Falah means success in the world and the hereafter.

6.0 Is IB Diverging from its Ideal State?

The strict interpretation of the *hadith* in relations to trade and commercial transactions prompts some Islamic scholars to ban the use of derivative products such as futures and options. This is because these financial-derivatives transactions involve items which the sellers do not have in their possession (Khan, 2010). In contrast to strict scholars, some lenient Islamic scholars approve the use of futures and options as long as the contracts used in the products are acceptable according to *Shari'ah* and could benefit society (Smolarski, Schapek, & Tahir, 2006). For instance, the usage of *Murabaha*²⁰ and *Bay' al 'Inah*²¹ is approved by Malaysian Islamic scholars but these are not accepted by Middle Eastern Islamic scholars (Muda & Jalil, 2007).

This is an example of the dynamic nature of IB. The differences in the interpretations of Islamic law by Islamic scholars of different *mazhabs*²² contribute to the development of the IB products offered in the market (Thomson, 2000; M. R. Zaman & Movassaghi, 2001). For instance, the *Shafii*²³ school is most common in Malaysia (Kuo, 2009). As well as the differing opinions between different schools of thought and their influence on IB, it is also influenced by the different opinions of scholars from different countries, all of which contributes to the dynamism of IB in the global arena. Therefore, the ideal for IB varies considerably.

However, the general consensus by Islamic economists is that Islamic banks should have a bigger asset composition based on equity such as *musyarakah*²⁴ and *mudharabah*²⁵

²⁰ A contract of sale in which payment is made some time after the delivery of the goods transacted. Used as the basis of modern IB since the amount charged for deferred payment is in excess of the current market price (usually by an amount approximately equivalent to the prevailing rate of interest).

²¹ Sell and buy back. Refers to a contract which involves selling and buying back transactions of an asset by a seller to the customer. The seller will sell the asset on a cash basis but the customer will buy back the asset on deferred payment at a price higher than the cash price.

²² There are four major schools of thought based on four Islamic scholars (*Hanafi, Maliki, Hambali and Shafii*).

²³ One of the four major schools of thought.

²⁴ A partnership. This is like a joint-venture agreement, which stipulates the conditions of a partnership. In order to be in line with Islamic law, both parties must participate in profits and losses, not just in profits. This technique can be used for short-term financing.

²⁵ This is a profit sharing contract. In such a contract, one party provides capital, and the other manages the enterprise. If there is a loss, the provider of capital bears the financial loss while the worker loses his labour. If there is profit, both parties share it in accordance with the proportions agreed upon at the time of the contract.

contracts in order to promote risk-sharing practices (Muda & Jalil, 2007). These contracts are categorised as 'strongly Islamic forms' instead of debt-based products, which are classed as 'weakly Islamic forms' (Khan, 2010). In reality, the ideals of IB are diverging from the current state of Islamic banks because IB's main concern is with the weakly Islamic form (so it erodes the spirit of goodwill). Nevertheless, Malaysian IB, despite using weakly Islamic forms of products, is growing at an enormous rate and so contributes to the growth and development of the Malaysian economy. The critiques on IB are that it is in divergence from an ideal and these are made by IB advocators, who claim that IB replicates CB by transforming the conventional money-lending practice into approved *Shari'ah* financial transactions, and these views have created divided perceptions (Khan, 2010; Muda & Jalil, 2007; Rosly & Abu Bakar, 2003; N. Zaman & Asutay, 2009). This has led some to question whether consumers perceive that IB complies with *Shari'ah* and whether this has an effect on the selection of IB and its impact on the overall satisfaction of customers. Even the customers in other part of world such in Thailand also face the same phenomenon, the consumers expected that the Islamic banking to achieve more social objectives rather than commercial objectives (Lateh, Ismail, & Ariffin, 2009). This paper, suggests that future studies should identify and fill the gap between Islamic banks' aggressiveness in marketing products and customers' satisfaction that the banks must be *Shari'ah* compliant at the same time taking religious and social obligations into consideration.

7.0 Discussion

This paper has introduces the origin of IBF in which it is a part of Islam and an act of submission to God by Muslims. IBF is guided by the *Shari'ah* rules and regulations and must be developed from the underpinning theory of Islamic economics. Under the Islamic economics, IBF is categorised under private sector and it requires the other two sectors which are the public and social sectors to complete the economic functions. This paper has also explained the historical establishment and provided some evidences of the development of IBF globally and in the Malaysian context. The paper then focusses the discussion to Islamic banking because it is the biggest assets composition as compared to *sukuk*, *takaful* and Islamic funds sectors. The discussion on the underpinning theory that the Islamic banking system was discussed in which Islamic theorists have argued that Muslim consumers are rational because an Islamic utility model has two periods, i.e.

during lifetime and after death. Even though Islamic banking has reached its three decades of existence, the post purchase behavioural/satisfaction of the consumers subscribing Islamic banking is beyond reach especially when it involves with religious and social obligations. Therefore, satisfaction is beyond only material expectations, and most importantly, Islamic banks and their customers strive to achieve God's satisfaction by being obedient to God. In the context of the banking industry, this could be done by avoiding interest as promulgated in the divine revelations. Nevertheless, this is not a reason for Islamic banks to fail to deliver excellence in their service quality and customer satisfaction. This is because customer satisfaction is not an alien concept from the Islamic perspective - there are several verses in the *Al-Quran*, which relate to the importance of Muslims to live in excellence²⁶. Based on the *Al-Quranic* verses, Islam encouraged Muslims to be preeminent in doing righteous deeds, and this can be translated into the IB operational system by providing high service quality to ensure customer satisfaction. Therefore, the two important and related concepts, i.e. service quality and customer satisfactions should be examined accordingly to the two time horizons i.e. during lifetime and after death in which it requires either a re-modification of the existing satisfaction model or an invention of a new model to accommodate the unique characteristics of Muslim consumers' behaviours.

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²⁶ For example see *Surah Al-Mulk*, Verse 2 and *Surah An-Nahl*, Verse 128.

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