



Islamic banking in South Africa - form over substance?

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Meditari Accountancy Research

***Islamic banking in South Africa – form
over substance?***

Abstract

The purpose of this study is to understand the economic substance of Islamic banking transactions in South Africa and to analyse whether the economic substance is closely related to the legal form. Additionally, this study highlights the similarities and differences in the execution of Islamic banking transactions across the different South African banks. The transactions analysed are deposit products of *qard* and *mudaraba* and financing products of *murabaha*, *ijarah* and diminishing *musharaka*. The study was conducted through interviews with representatives from each of the four South African banks which offer Islamic banking products. Interviews were semi-structured and allowed for interviewees to voice their perspectives increasing the validity of the interviews. The study found that the specific *Shariah* requirements of Islamic banking transactions are considered and included in the legal structure of the contracts by all four banks offering Islamic banking products. However, the economic reality of these transactions was often significantly different to its legal form and was found to, economically, replicate conventional banking transactions. The study also found that all four banks offer Islamic banking products under the same *Shariah* principles, but in some instances (e.g. diminishing *musharaka*) execute these transactions in different ways. This study is the first of its kind in South Africa. The study adds to the Islamic banking literature by analysing the real execution of Islamic banking transactions rather than the theoretical compliance with *Shariah* law.

Key words: *Islamic banking, qard, mudaraba, murabaha, ijarah, diminishing musharaka*

1. Purpose, context and significance of the study

Islamic banking has seen phenomenal growth since its earliest experiments in Egypt in 1963 (Ariff, 1988). Islamic banking held US\$1.8 trillion in assets globally at the end of 2013 and Islamic banking products were offered in more than 70 countries (Nazim & Bellens, 2013). The minority Muslim population of South Africa introduced Islamic banking through Al Baraka Bank which opened its doors in 1989 with HBZ Bank following in 1995. Islamic banking gained prominence in South Africa when two of the Big Four conventional banks, First National Bank (FNB) and ABSA, introduced Islamic banking windows in 2004 and 2006 respectively (Nazim & Bellens, 2013).

Islamic banking is a manifestation of contemporary models of Islamic economics (Al-Arabi, 1966; Khan, 1986) and the concept of an alternate financial order, both of which include a moral and societal aspect missing from Western or secular economics (Ariff, 1988). Islamic banking is distinguished by its interest-free philosophy. The *Quraan* (the Holy Book of Islam) explicitly prohibits charging or taking of *riba* (interest), regardless of the reason for the loan or investment. Prohibitions in Islam are for the purpose of promoting societal welfare, yet each prohibition allows viable alternatives, for example, wine and pork are prohibited for consumption in Islam but many other foods and drinks are allowed. Similarly, Islam allows profit-and-loss-sharing (PLS) arrangements as the alternative to interest-based transactions. Profit-and-loss sharing illustrates capital as a factor of production, while profits earned merely because of the passage of time (interest) are not allowed.

Conceptual criticisms of contemporary Islamic banking have been noted since inception. Studies by Usmānī & Taqī (1999); Kahf (1999); Karim (2001); Zaher and Kabir Hassan (2001); Laldin and Furqani (2012); Chong and Liu (2009) and Kahn (2010) to name a few, criticised the application of PLS principles and the inclusion of non-PLS transactions into the Islamic banking business model. Islamic banks formally state, using the relevant *Shariah* terminology, the types of PLS and non-PLS transactions offered and the terms and conditions of each type of transaction. *Shariah* texts are widely interpreted and applied with little regulation for consistency (Kamla, 2009). *Shariah* Supervisory Boards, the in-house *Shariah* counsel of all Islamic banking institutions, lend legitimacy to transactions by a process of formal approval when in compliance with *Shariah* (Mansoor Khan & Ishaq Bhatti, 2008). Common members on the *Shariah* Supervisory Boards of different Islamic banking institutions ensure consistency to some degree (Bassens *et al*, 2010), however, there is no literature to support or dispute this. While the above studies have widely debated the risk-

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3 sharing element of PLS transactions and the permissibility of use of non-PLS transactions,
4 no specific research has been done on the practical execution (transactional analysis of
5 Islamic banking transactions) at an individual bank level, and whether these transactions
6 meet the requirements of *Shariah*.
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10 Islamic banking in South Africa is still in its infancy in terms of both market penetration and
11 length of operations. Only two of the Big Four South African conventional banks (ABSA and
12 FNB) offer Islamic banking products and the two other market participants are small
13 subsidiaries of international banks. Islamic banks in South Africa only offer *qard* and PLS
14 based *mudaraba* transactions for deposits and offer the PLS-based diminishing *musharaka*
15 as well as the non-PLS based options of *ijarah* and *murabaha* for financing. Modes of
16 Islamic deposits and financing are explained in Section 2.2 below.
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23 To date, only two studies have been performed on the South African Islamic banking market,
24 Abdullah (2010) and Vahed and Vawda (2008). Both of these studies focused on the
25 consumer who transacts with Islamic banks, and not on the Islamic banking products. The
26 purpose of this study is to understand the economic substance of Islamic banking
27 transactions in South Africa and to analyse whether the economic substance is closely
28 related to the legal form. Additionally, this study highlights the similarities and differences in
29 the execution of Islamic banking transactions across the different South African banks. This
30 study is the first of its kind in South Africa.
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36 **2. Theoretical and analytical framework**

37 **2.1. Theological constructs of Islamic banking**

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40 The central belief of Islam is that the universe and all that is in it is controlled by one true
41 God, the Almighty Allah. He created man and put man on earth to fulfil certain objectives by
42 obeying His commands. The commands of Allah (SWT) do not focus solely on religious
43 rituals but cover every aspect of life. These commands are not so narrow as to leave no
44 room for human intellect nor are they so broad as to be ambiguous and open to perception
45 or desire. As such, Islam has provided human beings with a set of principles to govern their
46 activities. The vast capabilities of human intellect are limited by subjectivity and human
47 emotion which then limit humans' ability to reach truth. The principles provided by Allah
48 (SWT) through His Messenger Muhammed (Peace Be Upon Him) counter that limitation,
49 and, if obeyed, create a just and fair society (Uṣmānī & Taqī, 1999).
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3 The basis of Islamic commercial transactions, derived from Islamic jurisprudence, inherently
4 embody Islamic principles of balance, fairness and distributive justice. An Islamic banking
5 system, by definition, should be differentiated by being (i) interest free, (ii) multi purposed (not
6 merely commercial) and (iii) equity-oriented (Ariff, 1988). This illustrates the concept of Islam
7 as a way of life, permeating all areas of life, rather than being merely a religious pursuit.
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12 There is overwhelming literature (Kamla, 2009; Beck *et al*, 2013; Salleh, 2012) on how the
13 differentiating factors listed above do not form part of the core business model of Islamic
14 banks. Chong and Liu (2009) conducted a study on the correlation of Islamic banking to
15 conventional banking returns and concluded that overall Islamic deposits are not much
16 different from conventional deposits. Changes in interest rates prompted changes in Islamic
17 deposits investment rates while the reverse was not true. Rethel (2011) further analysed
18 whether ethical and moral dimensions were included in Islamic banking, and found that
19 Islamic banking is more concerned about presenting itself as normal financial activity and
20 largely reproduces conventional banking. PLS based transactions are logically expected to
21 be the cornerstone of Islamic banking; however, Islamic banking has evolved to include
22 ordinary trade transactions (non-PLS) based on *Shariah*¹ principles. Chong and Liu (2009),
23 as well as Laldin and Furqani (2012), noted that PLS transactions were being replaced by
24 ordinary trade transactions to the extent that only negligible numbers of transactions were
25 PLS based. Non-PLS transactions make up more than 90% of Islamic banking transactions
26 (Khan, 2010).
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36 **2.2. *Shariah* requirements of Islamic banking transactions**

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39 The *Shariah* law requirements of each of the Islamic banking transactions analysed as part
40 of this research have been detailed below. An understanding of these requirements is
41 necessary to understand the legal structure as well as the economic substance of Islamic
42 banking products offered in South Africa.
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¹ *Shariah* is the sacred law of Islam. It is derived from four sources: the *Qur'an* (the Holy Book of Islam), the *Sunnah* (the sayings and deeds of Prophet Mohammed (Peace Be Upon Him) and that which the Prophet Mohammed (Peace Be Upon Him) approved and disapproved of), *Ijma* (consensus of companions of the Prophet Mohammed, (Peace Be Upon Him)) and *Qiyas* (reasoning by analogy).

2.2.1. *Qard* transactions

In Arabic, *qard* literally means 'to cut'. This is in reference to the lender 'cutting off' the asset from him and giving it to the borrower. *Qard* is a loan which a person gives to another as a help, charity or advance for a certain time. One of the key features of *qard* is that its payable on demand. Another distinguishing characteristic of *qard* compared to other forms of Islamic loans is that the same quantity of a similar commodity can be returned to the lender. This allows consumable and non-consumable assets to be loaned on a *qard* basis. (Uṣmānī & Taqī, 1999).

2.2.2. *Mudaraba* transactions

Mudaraba, the chosen mode of allocating returns to depositors for Islamic banks in South Africa, is a partnership between two parties where one partner provides capital while the other contributes expertise and management of the business. During the period of this partnership, the capital provider has no involvement in the day-to-day operations of the business. Profits are shared on a pre-arranged basis but losses are borne solely by the capital provider (it is presumed that the hard work and effort without compensation is the loss of the other partner). Another distinguishing feature of *mudaraba* is that any assets purchased by the partnership remain the property of the capital provider and any unrealised capital appreciation cannot be shared with the other partner. If the assets are sold and a profit made, those profits may be shared on the pre-arranged basis (Uṣmānī & Taqī, 1999).

2.2.3. *Murabaha* transactions

Like *ijarah*, *murabaha* transactions are for general commerce and not financing. In its true Islamic connotation, *murabaha* is a specific type of sales transaction whereby the seller discloses the cost of his commodity and the mark-up to the buyer. As such, the rules relating to sales transactions apply. According to Islamic jurisprudence, for a sale to be valid, the sale commodity must physically exist at the time of the sale, owned by the seller and the seller must have physical or constructive possession of the commodity. Furthermore, the sale must be instant and absolute (i.e. sale at a future date is not allowed), the delivery of the commodity should be certain and the price must be certain. Islamic sales transactions are unconditional (Uṣmānī & Taqī, 1999).

A sale that is concluded on a deferred payment basis is referred to as *bai' muajjal*. In this type of transaction, the date of the payment in the future should be fixed in an unambiguous

manner and the deferred price may be different from the cash price. Islamic banks use a combination of the *murabaha* and *bai' muajjal principles* to finance assets. Often, the customer purchases the asset from the supplier on behalf of the bank (as an agent) and then offers to purchase the asset from the bank (at a mark-up). Similar to *ijarah*, the agent agreement is separate to the sale agreement and any conditions attached to the agency agreement or the sale agreement will render both agreements void. If the bank does not assume ownership risk (preferably physical possession) between the date of delivery from the supplier and the date of conclusion of the *murabaha* transaction, the conditions for sale will not be met (Uṣmānī & Taqī, 1999).

2.2.4. *Ijarah* transactions

Ijarah is a term that relates to the usufruct of assets and lexically means 'to give something on rent'. It is analogous to leasing. *Ijarah* is not a mode of financing in origin, but rather a normal commercial activity, like a sale. (Uṣmānī & Taqī, 1999).

A number of conditions should be met for a transaction to qualify as an *ijarah* transaction. Firstly, there should be an identifiable asset, a clearly identifiable owner, and lessee whereby the owner transfers the usufruct of the asset to the lessee for an agreed period, at an agreed consideration. The consideration should be absolutely determined at inception for the duration of the contract. Ownership remains with the owner and only the right to use the asset is transferred to the lessee. Anything which is consumed by use therefore cannot be leased. Costs relating to ownership should be borne by the owner while costs relating to use should be borne by the lessee. The lessee should compensate the owner for any costs as a result of negligence; however the owner retains full risk and is liable for all losses beyond the control of the lessee. The lease period commences on the date the lessee takes possession of the asset. The lease terminates at the agreed date or if the leased asset has totally lost the function for which it was leased. Ownership of the lease remains with the owner after the lease has been terminated. If the parties wish to renew the lease, or if the owner wishes to sell or give the asset to the lessee, it will form part of a new transaction (Uṣmānī & Taqī, 1999).

When *ijarah* is the mode of financing and the lessee procures the asset to be leased, it should be understood that the procurement of the asset is independent of the *ijarah* transaction. The procurement is a principle-agent transaction where the lessee acts as the bank's agent. Cost associated with transfer (e.g. customs and transport) should be borne by the principle. *Ijarah* conditions are not applicable during procurement and lease payments

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3 are not due until the asset has been delivered and the *ijarah* contract agreed (Uṣmānī &
4 Taqī, 1999).

6 **2.2.5. Diminishing *musharaka* transactions**

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9 *Musharaka* is a form of partnership which literally means 'sharing'. In a business context, it
10 means a joint arrangement whereby all partners share in the profits and losses of the joint
11 arrangement. Profits may be shared on an agreed upon ratio, but losses must be shared in
12 direct proportion to each partners holding in the joint arrangement. The normal principle of
13 *musharaka* is that each partner has a right to take part in the management of the joint
14 arrangement, however, the partners may agree on a condition that the management will be
15 carried out by one of them. In that case the silent partner cannot be entitled to a profit ratio
16 greater than the value of his investment in the joint arrangement. *Musharaka* agreements
17 may be terminated through the purchase of shares of one partner from another (Uṣmānī &
18 Taqī, 1999).

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26 Diminishing *musharaka* is a form of *musharaka* developed recently whereby two (or more)
27 partners enter into a joint arrangement over an asset with the one party having exclusive use
28 of the asset. The partner using the asset then pays rental to the other partner (or partners)
29 for the use of their share of the asset. A key feature of diminishing *musharaka* is that the
30 partner using the asset undertakes to systematically repurchase the shares from the other
31 partner (or partners) over a period of time. A diminishing *musharaka* agreement should be
32 effected over four stages. Firstly, joint ownership of the asset comes about when both
33 partners (assuming only two partners to the agreement) contribute to the acquisition of the
34 asset. Secondly, the one partner leases his share of the asset to the other partner who
35 occupies or utilises the whole asset. Thirdly, the partner occupying or using the asset
36 undertakes to systematically purchase the other partners share in the asset in equal
37 instalments over time. The third stage cannot be a condition of the original *musharaka* (stage
38 one) as it will cause the *musharaka* contract to be void, rather it should be structured as a
39 separate promise. The original *musharaka* agreement and the systematic repurchase of the
40 other partners share by the occupying partner may not be contained in the same agreement.
41 The original *musharaka* agreement and the agreement to lease may be contained in the
42 same agreement. Fourthly, at each date of repurchase, the repurchase price should be
43 offered and accepted at that date. It is preferable that the repurchase price be based on the
44 market value of the asset at the repurchase date; however, purchase prices may be pre-
45 agreed (Uṣmānī & Taqī, 1999).

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Meditari Accountancy Research

3. Research methodology

3.1 Research paradigm

Research in the accounting sphere has largely been conducted using positivist research with objective empirical evidence supporting conclusions and generalisations (Maroun, 2012). As Maroun (2012) points out, accounting is far more complex than formal quantitative research allows and may benefit from 'alternative' or interpretive/critical research. Critical research has its roots in Marxist philosophy and seeks to challenge 'taken for granted' social, political and economic structures and expose structures of power or domination, therefore assuming that there are marginalised groups whose best interests are not served by existing structures (Cannella & Lincoln, 2004). While critical research is more subjective, it allows for social and societal aspects to be included which may not be covered in quasi-scientific positivist research. Subjectivity does not detract from validity and reliability of the research; rather it is achieved from full disclosure by the researcher on the perspective of the study, detailed documentation of findings and rigorous data collection and analysis (Creswell *et al.*, 2010; Maroun, 2012).

Due to the minimal research conducted on Islamic banking in South Africa, a qualitative approach of detailed interviews was used, grounded in critical epistemology (Creswell *et al.*, 2010; O'Dwyer *et al.*, 2011; Maroun, 2012). This research adopted a strong advocacy approach with the aim of bringing change to Islamic banking in South Africa (refer to Section 1.1).

3.2 Method

Detailed interviews are the best method for obtaining facts and gaining insights into understanding the reasons behind certain actions (Rowley, 2012). Interviews are especially useful for researching new or less-explored areas (Creswell, 2013). Questionnaires were considered but discarded due to the varied and detailed nature of information sought as this research is focused on the breadth and depth of information rather than quantum, which is better obtained through interviews. Interviews further have the potential to provide the researcher with research angles not contemplated in this research (Rowley, 2012). Lastly, as key people in the Islamic banking industry in South Africa were targeted, it was more likely that these busy people would be willing to share their insights and opinions during interviews than taking the time out to fill out questionnaires (Rowley 2012).

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3 Prior research on Islamic banking largely used publically available information (Kahf, 1999;
4 Karim 2001; Zaher & Kabir Hassan, 2001; Laldin & Furqani, 2012; Kamla, 2009; Rethel,
5 2011) or questionnaires (Wajdi Dusuki & Irwani Abdullah, 2007; Bassens et al., 2010; Beck
6 et al., 2013) to conduct research, resulting in research that is one step removed from what is
7 happening in practice. Interviews with senior management at Islamic banks in South Africa
8 allow the researcher to walkthrough the execution of a transaction as would be done in day-
9 to-day operations providing the insight and information to perform the research analysis.
10 Interviews were, therefore, selected as the basis for acquiring data for this research.
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17 *Shariah* law, including its moral and societal aspects, and the basic understanding of Islamic
18 banking transactions in South Africa as obtained from the relevant bank's websites were
19 used to develop the interview agenda. The interview agenda was subject to peer review by
20 supervisors, fellow researchers at the University of Witwatersrand and was piloted by two
21 partners (familiar with Islamic banking) at Big Four audit firms; as recommended by Llewelyn
22 (2003), O'Dwyer *et al.* (2011), Maroun (2012) and Rowley (2012).
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28 Subjectivity and the researcher's involvement in the collection of data are some of the
29 characteristics of interviews (Creswell, 2013). These characteristics are unique to qualitative
30 research but do not detract from the validity or reliability of the method (Creswell *et al.*,
31 2010). Researcher bias could be a factor in one of the processes of setting up, holding,
32 transcribing or analysing interviews (Creswell, 2013; Rowley, 2012) and threaten reliability.
33 In this study the researcher ensured that only experienced interviewees were chosen
34 (Section 3.2.1), that the interview agenda was appropriately designed and tested and that a
35 thorough analysis of the data was performed resulting in reasonable assurance on the
36 reliability and validity of findings (Creswell, 2013; Rowley, 2012).
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43 **3.2.1 Sample**

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46 In order to understand the operational economics of Islamic banking transactions, people
47 who oversee the development and execution of these transactions at Islamic banks in South
48 Africa were selected to be interviewed. At least two members of senior management at each
49 Islamic banking institution in South Africa were selected to participate in the research. The
50 result was that senior executives who operate Islamic banks in South Africa were engaged
51 until saturation was achieved (Rowley, 2012). All interviews were semi-structured to ensure
52 focus on the research question and to thoroughly examine the subject (Holland, 2005; Leedy
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3 & Ormrod, 2014; Rowley, 2012). As recommended by Rowley (2012), a total of 9 interviews
4 were conducted, ranging between 40 minutes and 90 minutes each.
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7 8 **3.2.2 Ethical considerations** 9

10 Interviewees were granted personal anonymity to guarantee their full co-operation (O'Dwyer
11 *et al.*, 2011). However, participants were advised and did not object to the Islamic bank or
12 conventional bank offering Islamic banking products being specifically mentioned in the
13 research report. Participants were interviewed in familiar settings so that they would be at
14 ease (Rowley, 2012). Interviewees were granted the power to stop the interview at any time
15 which was designed to contribute to their willingness to participate and be forthcoming
16 (Creswell *et al.*, 2010). During the review of the interview agenda, peers, colleagues and
17 people involved in the pilot study were be requested to provide feedback on whether any of
18 the questions pose an ethical dilemma for interviewees.
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25 26 **3.3 Data collection** 27

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29 Data collection and analysis utilised a case study approach with the researcher continuously
30 analysing actual South African Islamic banking transactions with reference to its ideal
31 *Shariah*-compliant counterpart. Certain interviewees were expected to have full knowledge
32 of *Shariah*. As the purpose of the research was to understand the economic substance of
33 Islamic banking transactions, participants were asked indirect questions without the
34 researcher leading or directing the interviewee down a certain path.
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39 40 **3.4 Data analysis** 41

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43 Data analysis commenced with a detailed review of prior literature on the *Shariah* relevance
44 and compliance of current Islamic banking practices globally. The aim was not to summarise
45 every argument for or against current Islamic banking, but rather to identify the major
46 advantages and pitfalls of modern-day Islamic banking. The reviewed literature was
47 organised using a content analysis.
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52 Data obtained from transcripts was analysed several times through data reduction, data
53 display and data verification (O'Dwyer *et al.*, 2011). Themes were naturally identified as the
54 four different types of Islamic banking transactions offered in South Africa. Data was initially
55 analysed on a holistic level by analysing the business model of each bank offering Islamic
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3 banking transactions. Next, the *Shariah* requirements of these transactions formed the
4 categories by which interview data was organised (Rowley, 2012).
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8 An informal coding scheme was developed to analyse the more subtle themes in the
9 interviews. Specific attention was paid to contradictions within interviews and amongst
10 interviewees (Patton, 2015). Subsequent readings of the transcripts added to these themes
11 and this process was repeated until a sense of saturation of the issues was experienced by
12 the researcher (Holland, 2005; Leedy & Ormrod, 2014; O'Dwyer *et al.*, 2011).
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16 17 **3.5 Limitations**

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19 While safeguards have been employed to ensure the reliability and validity of the research,
20 there are still a few inherent limitations which should be noted:
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23 • Interviewees, while chosen for their expertise and level of knowledge, may provide
24 highly technical insight which may be difficult to interpret. Detailed technicalities were
25 therefore excluded from this research.
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28 • The regulatory environment of banks in South Africa, for example regulation imposed
29 by the Financial Service Board on all financial institutions in South Africa, has not
30 been explored. However, the regulatory environment was brought to the readers'
31 attention to help illustrate certain themes.
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34 • This research uses only *Shariah* requirements as detailed in section 2.2 to analyse
35 transactions. *Fatwas* (rulings) issued by the *Shariah* Boards of South African Islamic
36 banks have not been included in this study and may be an area of future research.
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4. Findings

4.1. Overall findings

Each of the banks that offer Islamic banking in South Africa offer both deposits and financing products. All of the banks included in the study offer the equivalent of a conventional cheque or current account on a *qard* basis on which no returns are paid to the customer. All of the banks also offer customers the option of several types of savings accounts on which returns are earned on a pre-agreed basis under the PLS-based *mudaraba* (equity investment) principle. On the financing side, all of the banks offer property finance under PLS-based diminishing *musharaka* (partnership), although this is executed differently at each of the banks. HBZ Bank also offers motor vehicles and asset finance under diminishing *musharaka* (partnership). The non-PLS mode of financing, *murabaha* (cost plus) is used by Al Baraka Bank to offer motor vehicle, asset and property finance with a maximum term of 7 years. *Murabaha* (cost plus) transactions are used by HBZ Bank only for trade finance (e.g. inventory) with a maximum term of 90 days. The other non-PLS modes of financing, *ijarah* (leasing), is used by ABSA and FNB Islamic banking windows for motor vehicle and asset finance. A summary of the transactions offered by each bank including the transaction modes (i.e. PLS or non-PLS) are tabulated in Table 2.

Table 1 - Types of Islamic banking transactions available in South Africa per bank

	Al Baraka Bank	ABSA	FNB	HBZ Bank
<i>Qard</i>	Deposits – no returns	Deposits – no returns	Deposits – no returns	Deposits – no returns
<i>Mudaraba</i>	Deposits – pre-agreed returns	Deposits – pre-agreed returns	Deposits – pre-agreed returns	Deposits – pre-agreed returns
<i>Murabaha</i>	Financing – trade financing (e.g. inventory), motor vehicles, equipment, property (max 7 years)	Not offered	Not offered	Financing – trade financing only (e.g. inventory)
<i>Ijarah</i>	Not offered	Financing – motor vehicle and asset finance	Financing – motor vehicle and asset finance	Not offered
<i>Diminishing musharaka</i>	Financing – Property	Financing – commercial property only	Financing – Property	Financing – property, motor vehicles, equipment

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3 Islamic banking has come under criticism globally for merely putting an Islamic veneer on
4 conventional products (Khan, 2010) and that sentiment continues to exist even amongst
5 those operating Islamic banks:
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7 'So the way we operate, [and the other banks] are similar and I think that it's a
8 problem across Islamic banks across the world in that at the moment we are
9 just trying to replicate conventional products, we are almost playing catch-up.'
10 (R3)
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14 'Islamic banking in South Africa is relatively new so people don't understand
15 the concepts, the closer it [Islamic banking] is aligned to conventional banking,
16 the more you get your market to take your product.' (R6)
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20 'The substance in essence is the same as conventional banking and is made
21 *Shariah* compliant in terms of the contract' (R8)
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24 25 **4.2. Findings on *qard* transactions** 26

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28 In Islamic principles, *qard* are loans given to another as a help, charity or advance repayable
29 on demand or at a specific time. In a South African Islamic banking context, Islamic banks
30 borrow money from depositors as advances to run the Islamic business (R5). Respondents
31 explained that operationally *qard* accounts are structured the same as conventional current
32 or cheque accounts on which no returns are paid.
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36 '...[On] the *qard* account we cannot give any profit on that account, because
37 the *qard* is there, we took the loan from the customers. If we took the loan
38 from the customer and we pay anything on that *qard* [it] is equal to interest.'
39 (R7)
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43 Islamic banks use *qard* funds to generate returns, yet do not pay any of these returns to
44 depositors as that would be interest and in contravention of *Shariah*. However, transaction
45 fees are still levied on *qard* accounts similar to conventional cheque and current accounts.
46

47 'So one element is the element of bank charges and the services we provide,
48 so we pride ourselves on the fact that we provide a service that is compatible
49 and on par with what the conventional bank offers.' (R5)
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53 Islamic banks have encountered complications when running promotions on the cheque
54 accounts, as any benefit derived by the depositor from having loaned the money to the bank
55 may be construed as interest.
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3 ...so for example on their cheque accounts we are giving a competition where
4 you could win tickets to something. So the *Shariah* questions were, can you
5 [the depositor] derive benefit and will it then be interest? So you'll have those
6 kind of issues where we're constantly going back to the *Shariah* board to say
7 we want to run this campaign or this promotion, can it work or can't it work
8 and how do we change it. What the *Shariah* board said, based on the
9 transaction, if you [can] get the customer to use his ATM three times a month
10 or whatever, based on that you can give a prize, but you cannot give a prize
11 for just having a cheque account.' (R3)
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17 **4.3. Findings on *mudaraba* transactions**

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20 Respondents confirmed that all deposit products on which returns are paid are offered under
21 the *Shariah* concept of *mudaraba* (partnership). Depositors' money is mobilised in a variety
22 of ways in order to earn returns. Respondents from each of the Islamic banks interviewed
23 declared a mismatch in that the value of money received from depositors was significantly
24 more than money loaned to borrowers. Excess cash available from depositors is invested by
25 the Islamic bank in equity or commodities or other short-term investments (R1, R3, R5, R7).
26 The returns from these investments are pooled and shared with depositors on the pre-
27 agreed profit ratio.
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34 The profit share percentage differed across each of the banks ranging from a 40:60 ratio,
35 with the bank taking 40% and the depositors receiving 60% of profits, to an 80:20 ratio,
36 where the bank keeps 80% of the profits and distributes to customers 20%. The difference in
37 profit ratios is attributed to the method of distributing profits which is done on a gross basis
38 before deducting the bank's operating expenses or on a net basis after deduction of the
39 bank's operating expenses (R7).
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45 One of the key features of a *mudaraba* profit sharing arrangement is that the depositor must
46 be exposed to the risk of losing capital for the transaction to be valid in terms of *Shariah*.
47 Respondents acknowledged that the risk exists but emphasised that the probability of the
48 depositor losing their deposits are slim.
49
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53 ...we don't want to put our customers fund at risk, because under *mudaraba*
54 it's a profit and loss sharing agreement, we try to minimise the loss by
55 structuring the trades so that when we buy [equity or commodities], we
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3 already know we can sell it in the market or we've got a buyer and we close
4 out.' (R3)
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7 In Islamic bank, there's a risk to the depositor and shareholder. The deposit is
8 not guaranteed, like any other institution also. In Islamic banking you
9 obviously have a higher risk. So in theory you can lose a deposit. In practice,
10 obviously, banks will put controls in place to try and restrict the losses but
11 Islamic banking...' (R1)
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16 **4.4. Findings on *murabaha* transactions**

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19 Only Al Barak Bank and HBZ Bank use *murabaha* as a mode of financing. Al Baraka Bank
20 uses this mode of financing to finance short-term assets such as inventory as well as longer
21 term assets such as equipment, motor vehicles and property. The maximum period over
22 which *murabaha* financing is offered by Al Barak Bank is 7 years. HBZ Bank uses *murabaha*
23 to finance inventory only with a maximum term of 90 days. *Murabaha* is a non-PLS mode of
24 financing and is better suited to ordinary trade transactions rather than financing. Islamic
25 banks in South Africa, however, deem the *murabaha* financing activities to be a form of
26 trade.
27

28 'We don't do lending or financing. Islamic banking, there is no concept in
29 Islam for lending or financing. We do **trading**. *Murabaha* is a **trading**
30 transaction.' (R7, emphasis added)
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37 Operationally, *murabaha* transactions involve a complicated set of processes and
38 agreements that are required to be fulfilled in a specific order for the transaction to be
39 *Shariah* compliant.
40

41 '...[if the] client [customer/borrower] wants to buy goods, [the] goods are
42 sourced [by the customer/depositor as the agent], and goods are [then]
43 delivered to the customer. Before the client uses the goods, the supplier
44 invoices the bank, and the bank pays the supplier. The customer cannot use
45 those goods once he receives them [those goods], until the bank sells him
46 those goods. The bank will then make the sale out to the customer. Say the
47 goods cost R100 000 we sell it to you [the customer/borrower] for R120 000
48 the amount is due in three months' time. When the customer accepts the sale
49 the customer can use those goods and can dispose of it. This is a[n] [inventory]
50 trade transaction.' (R1)
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3 A key feature of *murabaha* transactions is that both the buyer and seller know the original
4 cost price of the product and agree on the mark-up. Engaging in *murabaha* trade would
5 imply that the mark-up is based on the market price of the asset being resold. However, the
6 mark-up is based on the rate of return the Islamic bank wishes to achieve for depositors.
7

8
9 '... the transaction will be determined in terms of what the deposit rate is, [the
10 desired deposit rate will determine] what the profit mark-up is.' (R1)
11

12
13 Buying and selling of assets at a mark-up but allowing for repayment terms to extend over a
14 long period blurs the boundaries between a financing and a trade transaction. The financing
15 component creates regulatory complications in terms of the National Credit Act of 2005
16 (NCA) where section 125 (c) prescribes that, in the case of early settlement, the credit
17 provider may not charge more than a maximum of three months future interest forfeited as a
18 termination fee. In the case of *murabaha* transactions, it is not interest but rather the profit on
19 the mark-up that is received over the course of the contract. In terms of *Shariah*, the profit
20 remains the same regardless of settlement date and may not be reduced or altered after it
21 has been agreed upon by both parties. In order to retain *Shariah* compliance and comply
22 with the NCA, some of the Islamic banks interviewed require full settlement of the agreed
23 upon price and thereafter gift an amount back to the customer. Alternatively, Islamic banks
24 allow settlement of *murabaha* transactions at a discount.
25

26
27 'In practice if someone [a customer] comes and said [that they wished to]
28 settle early, we will give the person [customer] a discount, it's not a
29 contractual obligation it's a prerogative of the bank. We give a discount if we
30 wish. If you owe R125 000 after two years and you want to pay it off, we say
31 ok you can pay R105 000, a discount on the marked-up price, at the
32 prerogative of the bank.' (R1)
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41 **4.5. Findings on *ijarah* transactions**

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43
44 ABSA and FNB Islamic banking windows utilise the *Shariah* principle of *ijarah* or leasing for
45 the vehicle and asset financing, with ABSA utilising both a fixed and variable rental structure.
46 *Ijarah* is a non-PLS mode of financing. In order for *ijarah* transactions to be *Shariah*
47 compliant, the contract must be executed as an operating lease.
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51
52 ABSA and FNB Islamic banking windows follow the same processes as *murabaha* in
53 executing the transaction. To illustrate, if a customer wishes to purchase a motor vehicle the
54 client comes across to the bank and indicates that they need to buy a motor vehicle. The
55 Islamic bank then appoints the customer as an agent. The customer now sources the car
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3 from a motor car dealer and once the car is chosen, the motor car dealer makes out an
4 invoice to the Islamic bank, which means that Islamic bank effectively takes ownership of the
5 vehicle. Thereafter the transaction price is determined, and the vehicle is leased to the
6 individual at a mark-up.
7

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9 'Once we approve your credit, you find the vehicle; the bank purchases the
10 vehicle and leases it to you over a specified period of time.' (R6)
11

12
13 '[And you add a profit element to the cost before you lease it?] The *murabaha*
14 is the underlying structure for most Islamic transactions; it's more the overlay
15 in term of all the other obligations that come through with all these other
16 structures [i.e. *ijarah*].' (R5)
17

18
19 At the end of the lease terms the car is transferred to the customer for no consideration or
20 given as a gift to the customer.
21

22when he [the customer] makes his final payment in the lease, he'll get the
23 final documentation where ownership is transferred.' (R5)
24

25 The mark-up added to cost of the asset before it is leased is not based on the market price
26 of the asset leased but rather determined using conventional banking benchmarks.
27

28 'So we base it [the mark-up on *ijarah* transactions] on [the bank's] lending
29 rate. Essentially from our perspective, from [the larger bank's] perspective, the
30 pricing issue was that we want to standardise pricing, whether it is
31 conventional or Islamic, you [the customer] are paying the same price. So the
32 view from the *Shariah* scholars, whether we benchmark it through [the bank's]
33 rate or the prime rate does not make that [the transaction] not *Shariah*
34 compliant, because the benchmarking is not the issue, it's the actual interest
35 that's the issue.' (R3)
36
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40 The only difference between the structure of the *murabaha* and *ijarah* transactions is that in
41 the *ijarah* transactions, the Islamic bank retains the title deeds of the asset even though
42 ownership passes to the customer.
43

44 'The reason you do that [retain title deeds but transfer ownership] in an operating lease type
45 structure is that the customer is responsible for servicing the vehicle, if he [the customer] has
46 an accident, he [the customer] can't tell the bank it's your [the bank's] car, you [the bank] fix
47 it.' (R5)
48

49
50 The structure of *ijarah* transactions bypass the complication of compliance with the NCA as
51 explained under *murabaha*. If the customer wishes to settle early, the rental for the period
52 the car was used is charged and if the customer wishes to purchase the vehicle, a price is
53 then negotiated.
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56 '[Would the customer pay less than the total value of lease payments?]' 'Yes,
57 because then you [the customer] are basically purchasing out the rest of the
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3 period of the rental. So then we [the Islamic bank] would negotiate a price.
4 When we [the Islamic bank] negotiate a price, we [the Islamic bank] can
5 negotiate cheaper than the full period rental. And that's what happens in
6 conventional [banking], they would give you a discount.' (R3)
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4.6. Findings on diminishing *musharaka* transactions

Al Baraka Bank, ABSA, FNB and HBZ Bank each offer property financing under the *Shariah* principle of diminishing *musharaka*. ABSA uses this mode of financing for commercial property only while HBZ Bank uses this mode of financing for commercial and residential property, motor vehicles and equipment. Al Baraka and FNB finance both commercial and residential properties under diminishing *musharaka*.

As *musharaka* is a form of partnership, where both the bank and the customer make contributions to the partnership but only the customer uses the asset of the partnership. Included in this agreement is an undertaking by the customer to purchase back the bank's share of partnership and ultimately become the sole owner of the asset. This repurchase is usually structured in instalments over a number of years.

'So in the [diminishing] *musharaka*, what happens is that, say the property is R10 million and we [the Islamic bank] tell you we want a deposit of 20%, so that R2 million becomes your [the customer's] equity in that property, so you [the customer] own 20% and we [the Islamic bank] own 80% and we [the Islamic bank] would fund the 80% of the property, so we [the Islamic bank and the customer] are in a partnership on the property. We [the Islamic bank] would follow the normal process in terms of registering a bond and all of that because that's the normal requirements.' (R3)

'Over a period of say 20 years the 80% that the bank owns will be sold to the individual [customer]. In the first year you [the customer] own 20% the bank owns 80%. Assuming the bank sells you [the customer] 8% a year, the second year you [the customer] own 28%, the bank owns 72%, the third year you [the customer] own 36% the bank owns 64% etc. and it that way over a period of time the house ownership goes to the individual [the customer], that's how diminishing *musharaka* works.' (R1)

In South Africa, the Islamic banks use different methods to facilitate the buy-back of the shares by the customer. At ABSA and HBZ Bank, through a series of contracts, customers buy back the Islamic bank's share of the partnership at cost i.e. at the original value of the asset. In this instance, Islamic banks earn returns on diminishing *musharaka* transactions through charging a rental to the customer for use of the bank's share of the asset. In the example quoted by (R1) above, the bank would charge the customer a rental for 80% of the property occupied by the customer for the first year, rental for 72% of the property in the second year and rental for 64% of the property in the third year and so on.

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3 There are 3 agreements, the one is the *musharaka* the partnership
4 [agreement] the initial [agreement], then we have an undertaking to purchase
5 which basically says we [the Islamic bank] don't want to hold on to the
6 property, that's not our business and you [the customer] would undertake [to
7 repurchase the bank's stake] monthly or quarterly or however the payments
8 are structured and that will be done at cost. So over the term, every month
9 you [the customer] will repurchase the equity until you [the customer] own
10 100% and we [the Islamic bank] own 0. Then [The last agreement] we [the
11 Islamic bank] charge you a rental in proportion to our holding.' (R3)
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17 '[So diminishing *musharaka* uses *ijarah* principles as well? And only for the
18 capital you use *musharaka*?] Diminishing *musharaka* [is used] on the capital
19 side and *ijarah* [is used] on the rental side.' (R7)
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22
23 Al Baraka Bank and FNB, on the other hand, sell the bank's equity stake at cost plus a mark-
24 up once a year, in equal instalments calculated by dividing the Islamic bank's equity stake to
25 be sold over the period of the contract. Using the example cited by (R3) above (for a
26 property worth R10 million, the Islamic bank has an 80% equity stake and the customer has
27 a 20% stake), if the contract is over 10 years, the bank will each year, at the anniversary of
28 the contract sell 8% of its equity stake. Each year, at the anniversary of the contract, the
29 profit mark-up on the equity stake instalment to be sold in the next year is agreed. Profit
30 mark-up may therefore vary year-on-year. For example, an 8% equity stake sold by the
31 Islamic bank in year one may at a higher or lower amount than the 8% equity stake sold in
32 year two.
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38 '...you [the customer] sign a diminishing *musharaka* agreement. So a
39 diminishing *musharaka* agreement states that you will have use of the house.
40 There are quite a few things in terms of the use agreement; what you [the
41 customer] are allowed to do, what you [the customer] are not allowed to do.
42 Also the agreement would say over a specified amount of time depending
43 5, 10, 15 20 years, up to 20 years maximum, you can purchase the banks
44 interest in the property back over that period of time in equal chunks or it's up
45 to you. At the end of the 1st year, it's based on a 1 year fixed period; we will
46 sell you maybe another 10%, depending on the term, at a mark-up. So other
47 banks when you rent the house, there's a rental component and a resale
48 component, we cut out the rental component, we just sell you back the share
49 at a mark-up. [So then you [the Islamic bank] are using *murabaha* principles?]
50 Its *murabaha* entwined in a diminishing *musharaka*.' (R6)
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3 Similar to *ijarah* financing discussed above, the rental charged in diminishing *musharaka*
4 agreements is based on standard amortisation tables as used in conventional banking as
5 opposed to actual rental values the asset would generate.
6

7 'When we actually draft our lease amortisation schedules, we specifically draft
8 it in such a way that it actually accommodates the Islamic contract. So what
9 we do, we actually assign R1 equals to 1 unit so whatever capital you [the
10 customer] are paying off, it actually shows that this is the repurchase of units
11 on diminishing *musharaka*. And whatever rental portion or interest portion in
12 conventional terms is the rental allocated to those leftover capital units.' (R4)
13
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16 Likewise, the profit mark-up charged by the Islamic bank on sale of *musharaka* shares to the
17 customer is based on financing principles and returns payable to depositors rather than the
18 appreciation of the value of the asset since the original agreement.
19

20 'When we [the Islamic bank] are taking your [the *mudaraba* depositors]' one
21 year funds from you [the *mudaraba* depositor], we [the Islamic bank] are not
22 promising you [the *mudaraba* depositor], but we [the Islamic bank] are giving
23 you [the *mudaraba* depositor] an indicative rate on what one year returns will
24 be. So when we [the Islamic bank] are funding the one year on the other
25 [diminishing *musharaka*] side we [the Islamic bank] need to make sure that we
26 [the Islamic bank] are able to generate the profit to give you [the *mudaraba*
27 depositor] the return. So we [the Islamic bank] take all of those factors into
28 account when we are selling [marking-up] our stake in the [diminishing
29 *musharaka*] property.' (R6)
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36 Diminishing *musharaka* transactions are early settled when the customer buys back the
37 banks full share earlier than originally contracted for. Islamic banks that facilitate repurchase
38 by the customer of the Islamic bank's share at cost, allow more flexibility and allow early
39 settlement at any stage during the contract at cost. The resulting rental ceases as the
40 Islamic bank no longer owns any shares in the asset.
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43 '[If the customer wishes to purchase the banks entire share two months into
44 the contract? No problem, we [the Islamic bank] [will] take the rental for the
45 two months [that the asset was partly owned by the Islamic bank] then you
46 [the customer] pay back the principle [at the original cost of the asset].' (R7)
47
48

49 Early settlement of diminishing *musharaka* transactions where the Islamic banks resells the
50 equity stake at a mark-up may only happen once a year at the anniversary of the contract.
51 Equity sold to customers over the annual prescribed repurchase percentage (8% in the
52 example above) are at cost and do not carry a mark-up.
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55 'So we [the Islamic bank] are entitled to our year's profit that we [the Islamic
56 bank and customer] agreed upfront already. So remember, the diminishing
57 *musharaka* contract in year one, we enter into an agreement where over the
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3 year you [the customer] are going to buy back only [the prescribed] 8% share
4 at a mark-up. We [the Islamic bank] don't enter into an agreement to say the
5 rest of the years what that mark-up price is. So as a[n] [Islamic] bank we can
6 sell that to you at any rate going forward. But we [the Islamic bank] give you
7 an indication that during the term of the loan your rate will be the Islamic base
8 lending rate plus a profit mark-up. So we can sell it to you at just the Islamic
9 base lending rate, it's very flexible. So we give our customer a lot of flexibility.'

14 5. Conclusion and value of the study

17
18 Respondents interviewed as part of the study emphasised that Islamic banks have
19 implemented controls around, and regularly review, the legal structure of Islamic banking
20 transactions in South Africa for compliance with *Shariah* Law. At the same time most
21 respondents agree that Islamic banking in South Africa does not present an alternative
22 banking experience but rather replicates conventional banking. The findings further indicate
23 that each of the South African banks have innovated Islamic banking products so as to
24 maintain the *Shariah*-compliant structure and to comply with the regulatory and legislative
25 requirements of banking in South Africa.
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32 In terms of *Shariah*, *qard* transactions are loans granted to someone in need, however,
33 economically depositors are not loaning their money to Islamic banks due to the banks'
34 needs but rather as a mechanism for keeping money safe and to facilitate electronic
35 transactions. Similarly, *mudaraba* in *Shariah* is an equity investment in the business of a
36 bank; however, depositors merely use this platform as a convenient way to earn returns
37 without having to do the level of research equity investors would perform before investing
38 their money. In turn, the Islamic banks, while not guaranteeing *mudaraba* depositors' funds,
39 structure the banks operations so as to ensure that losses of those funds are highly
40 improbable, all of which indicates a relationship other than that of an equity investment.
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47 *Murabaha* and *ijarah* transactions are trade transactions under *Shariah*, which implies short
48 repayment terms (three months or less). Islamic banks however use these transactions for
49 long-term financing (three to seven year terms). Islamic banks ordinarily do not engage in
50 trade and apply rates of return as the profit margin on these transactions rather than
51 applying the market value of the product being traded. The period of the transaction and the
52 application of the profit margin results in the economics of *murabaha* and *ijarah* transactions
53 not being analogous to its legal form and instead resembling conventional financing
54 transactions.
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4 Diminishing *musharaka* transactions are a partnership in terms of *Shariah*, but are used as a
5 method of financing by Islamic banks. As this mode of financing is used mainly for owner-
6 occupied commercial and residential property, the partnership itself is not operated as a
7 business, earning its separate profits which are then split between the Islamic bank and the
8 customer. Islamic banks base profits charged to customers on these transactions (either
9 through *murabaha* or *ijarah*) not on property value or rental prices prevalent for other
10 properties in the area but rather on the bank's required rate of return.
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17 In conclusion, respondents were unanimous in that preference was granted to the legal and
18 contractual structure of Islamic banking transactions to meet *Shariah* requirements without a
19 matching consideration for its economic substance. There seems to be an element of
20 lethargy in addressing this lack of consideration, with none of the respondents interviewed
21 viewing the significant difference in economic substance and legal form as a pitfall of Islamic
22 banking or an area needing improvement. The overriding view was that legal structure and
23 economic substance do not necessarily demand the same answers and are, in fact,
24 independent of each other.
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30 This study is the first of its kind in South Africa. The study adds to the Islamic banking
31 literature by analysing the real execution of Islamic banking transactions rather than the
32 theoretical compliance with *Shariah* law.
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