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Parallel Universes: What Islamic Finance can Learn from Socially Responsible Investment

Frauke Demuth*

Abstract

The paper suggests that Islamic banks and financial institutions (IBFs) are by definition part of the ethical banking / investment niche, although they are rather oriented towards the conventional financial industry. The paper then sets out to explore what IBFs could learn from socially responsible investment (SRI). Two areas are identified that could provide fruitful solutions for the general critique of the Islamic financial industry as focusing too much on form and too little on substance: IBFs could seek cooperation with Muslim civil society actors in order to better understand the ethical requirements of their customer and potential customer base and it could use methods developed in SRI such as positive screening and impact investment to guide investment or more generally business decisions. The research presented in this paper is largely based on data collected in semi-structured depth interviews with Muslim representatives in Germany.

I. Introduction

By definition, Islamic Banks and Financial Institutions (IBFs) work within the framework of ethical banking / investment, because they are guided by more than just financial considerations in their decision-making processes (Kurtz, 2009: 250). The question of whether something is in line with the Islamic moral code, the *Shariah*, determines fundamental as well as everyday business decisions of IBFs and they are therefore part of the ethical banking niche of the financial market.

Despite this obvious association between Islamic finance and ethical banking / investment, there has been little to no interaction between actors of the two fields as was shown by Ünal (2013) in a recent network analysis.

Thoughts on why this might be the case shall not be part of the present paper. Instead, a more pragmatic stance is taken and the guiding research question will be what IBFs can learn from ethical banking and especially investment, also often referred to as socially responsible investment, SRI.

SRI is chosen as a particularly suitable point of reference, because it works at the interface between the “real economy” and the financial industry, which is also particularly important for Islamic financial theory (which is equity rather than debt based). In addition, the SRI industry has developed a number of methods and approaches that could be highly useful

* Ph.D Student, Durham University, UK

in developing the Islamic finance industry.

As was said before, Islamic finance is by definition part of ethical banking, but self-perception it seems, is focussed almost entirely towards the conventional financial industry. This orientation is illustrated by the ongoing debate among academics and practitioners of Islamic finance and Islamic economics about “form over substance” (e.g. El Gamal, 2006; Maurer, 2010; also Ali and Rainey, 2010, for a practitioner’s perspective). Critics claim that within Islamic finance, *Shariah* scholars, who determine the permissibility of a financial product from an Islamic point of view, focus too much on the application of the letter of Islamic contract law to rebuild conventional financial products in a *shariah*-compliant way, i.e. the form. Instead, they could for instance define comprehensive ethical as well as legal goalposts that help to realise broader Islamic principles as defined by Islamic economists. Asutay (2007) also talks about the “social failure” of IBFs in this context and claims that probably such moves cannot be expected from current IBFs and instead, more socially oriented new institutions such as religious trusts (*awqaf*) need to emerge.

In short, the Islamic finance industry can be seen and appears to see itself as taking conventional finance as a measuring rod and not so much the field of ethical banking and investment as one might expect.

This paper aims to show how a closer orientation of Islamic finance towards ethical investment / SRI could help to solve this problem of “form over substance” or the social failure of Islamic banks and financial institutions described above. It uses both literature on SRI and Islamic finance as well as data from a qualitative study using interviews with Muslim representatives from Germany on business ethics. First, both industries will be introduced in some detail to set the context and provide further background information.

II. Islamic Finance vs. SRI - Some Figures

Reuters estimated in 2012 that Islamic finance assets stood at about 1.3 trillion USD globally as at 2011 (Davies, 2012). Islamic funds were estimated at 58 billion USD for 2011 (Davies, 2012). The latest edition of the Islamic Finance supplement of specialist magazine the Banker states that in 2012, global *shariah* compliant assets stood at just below 1.3 trillion USD, although growth rates are still claimed to be single digit instead of double digit as in previous years (DiVanna and Hancock, 2013) (Possibly this contradiction is due to different calculation methods between the two publications). The Banker also states that the business environment for the industry is changing and that there are various major challenges such as a greater need for accurate documentation of *shariah* compliance. It also points out that despite the positive developments in the industry, actually less than 20% of Muslims in the world have access to or are willing to use Islamic banks and that the success has so far been driven mainly by corporate actors and wealthy individuals (DiVanna and Howards, 2013).

On comparison, figures for SRI in Europe and the US alone add up to over 12 trillion USD for the same year (based on the Eurosif, 2012 and USSIF, 2012 market studies). Thus, even considering that Islamic Banking encompasses many more financial products than SRI, its market volume is less than a tenth of SRI (considering that not all SRI invested assets are included in the figures above). Also in terms of growth rates, SRI is compatible with Islamic finance, with SRI in Europe having seen a growth of 35% between 2009 and 2011 (Eurosif, 2012). Also in terms of market share, SRI is well positioned as a measuring rod for Islamic finance. For instance, the latest Eurosif study (2012: 17) states that over a quarter of all invested assets in Europe are already screened against the exclusion of at least one non-financial criterion (e.g. weapons, tobacco, child labour, human rights violations etc.).

It can be seen therefore that SRI is a highly successful financial industry niche just as Islamic finance. At the same time, it has come up with a number of solutions to problems that both these niches have in common, e.g. regarding the issue of transparency of investment decision making processes and the outreach to poorer members of society.

The following section provides more information on the development of SRI and the methods used to illustrate these points and lay the ground for the analysis and discussion following in later parts.

III. Socially Responsible Investment in Relation to Islamic Finance - The Basics

In the introduction, it was claimed that Islamic finance is by definition ethical banking. Ayub (2007: 73) defines Islamic finance as follows: "*Islamic banking and finance has been conceived as banking and finance in consonance with the ethos and value system of Islam*." He states further that Islamic finance is guided by the *Shariah* and that central elements are the prohibition of interest (*riba*), uncertainty (*gharar*) and gambling (*maisir*). Furthermore, Islamic finance should aspire to fulfil the ethics of an Islamic economic system, which encompasses aspects such as social justice and contributing to the general development of humanity (e.g. Asutay, 2007).

Turning to SRI, the most basic definition has already been given, by which ethical investment / SRI means that non-financial criteria are integrated into the decision-making processes (Kurtz, 2009: 250). Thus, this encompasses any ethical concept or belief system and the focus points have changed both over time and depending on the types of investors and their motivation. Kurtz (2009: 251) differentiates between three different types of investors based on their motivation: a) value-based investors: investments should primarily be in line with their own ethical convictions; b) value-seeking investors: use ethical investments to improve their financial performance; c) value-enhancing investors: engage directly with companies via shareholder activism in order to further the value of an investment. A forth group that is gaining ground in recent years could be called 'value-defining investors' meaning those investors that re-define value by emphasising the social profit or impact created through their investments (see definition below for impact investment, the research methodology most closely related to this type of investor).

The beginnings of SRI are usually traced to religious groups like the Quakers that started in the 18th century to exclude companies from their business dealings which were involved in the slave trade, alcohol, tobacco and gambling (Schwartz, 2003) and one of the first modern SRI funds was initiated by Methodists in 1971 (Kurtz, 2009) that excluded arms producers as a reaction the Vietnam War (Osthoff, 2008). Other events that supported the development of the SRI industry were the boycott of South African companies to end apartheid in the 1980s as well as the strengthening of the environmental movement and the general debate on sustainable development (Visser, 2012: 14f).

This shows that SRI has been driven from its beginnings by faith-based actors as well as other civil society organisations. This seems significant for the question discussed in this paper of what Islamic finance can learn from SRI for several reasons. The emergence of Islamic finance can be linked to Islamic revivalism quite similar perhaps to the first development of SRI. However, other than SRI, the development of Islamic finance seems to have been driven mostly by political actors as well as interested individuals with a decidedly commercial orientation or even a background in conventional banking that set up the first Islamic financial institutions such as Dubai Islamic Bank (Haniffa and Hudaib, 2010; Warde, 2010). Thus, one could argue that there has been no debate on what should constitute an alternative financial system rooted within a broader Muslim civil society from the beginning of Islamic finance and this might be one of the reason it has such a low penetration among the general Muslim population. The data presented in this paper are a first attempt to bring Muslim civil society representatives' points of you to the Islamic finance industry, which will be explained in more detail in the methodology section.

Today, SRI many actors are involved and the original drivers mentioned above like civil society and churches are overtaken by institutional investors. In fact, much of the growth reported on in recent years is due to large institutional investors applying at least one of the SRI methods that will be discussed now in some detail (Eurosif, 2012).

There is a marked difference between SRI and Islamic finance when it comes to the choice of methods used for guiding and informing investment decisions. In Islamic finance, the most important instrument for deciding whether a product or an investment is within the ethical framework of a given IBF is the *shariah* board. Generally, every Islamic financial institution has its own *shariah* board, which consists of a number of scholars trained in a range of subjects such as economics, finance, legal studies or even arts (Ünal, 2010: 22), but usually with a strong knowledge of Islamic law that determine whether a new financial product is *shariah*-compliant. The way these decisions are brought about, are usually not made public in any great detail. For instance, the annual reports of Al Rahji Bank (the second largest Islamic bank in 2012 according to The Banker, 2013) and of Dubai Islamic Bank (the oldest Islamic bank; Warde, 2010) both only contain very brief sections with general statements on the activities of the Sharia supervisory boards.[1]

Transparency on the decision-making process in ethical investment is a major topic, too that will be discussed in more detail later on. But it can be noted already, that the sector has defined distinctive methods that can principally be used to help in making decisions with regards to the ethicality of an SRI investment (definitions are based on Eurosif, 2012):

Negative screening: Screens out investment objects that engage in controversial business activities such as weapon or alcohol production and business practices such as child labour. This method is also used in Islamic finance.
Best-in-class / positive screening: Investment objects such as companies with tradable shares or bonds are analysed against a set of criteria that define exemplary behaviour e.g. with regards to social engagement, environmental protection and corporate governance. Only those objects qualify for investment that reach a certain minimum standard.
Shareholder activism / engagement: Investors use their shareholder rights to confront their invested companies with critical issues and aim at instigating a more positive, ethical behaviour ‘from within’.
Impact investment: This relatively new type of socially responsible investment unites various types of investment that have in common that social or environmental projects or organisations are supported with a focus on generating a measurable positive social impact (instead or as well as a profit).
Integration: Environmental, social and governance criteria (ESG) are integrated into the financial analysis. This can be seen as a step to integrate ethical criteria into the mainstream financial industry and is therefore a hybrid strategy between conventional and socially responsible investment.

Most of the methods described above are mainly used for screening publicly traded shares or bonds. However, methods such as negative and positive screening and especially impact investment, but also integration, can be used in lending or project finance as well. Therefore, many methods used in SRI could be transferred to Islamic finance with its ideal of being a partner in finance rather than just a lender / creditor. As they are broad concepts, they could be modified to include Islamic principles. This would help to increase the transparency of the decision-making process and make the processes behind Islamic finance better

1 DIB Annual Report 2012: <http://www.dib.ae/investor-relations/financial-information/financial-reports> Al Rahji Annual Report 2012: <http://www.alrajhibank.com.sa/en/investor-relations/pages/financial-results.aspx> (both accessed Dec 08, 2013)

understandable for customers.

To summarise, this part aimed at introducing both Islamic finance and SRI in terms of basic market figures, definitions, actors and developments, methods and challenges as well as offer a first comparison of the two niche markets. Two aspects have been highlighted where Islamic banks and financial institutions might benefit from learning from SRI: consultation with civil society actors in order to get a better grasp of ethical expectations of Muslims towards their services and opening up to some of those methods developed by SRI. These two aspects will be further discussed now. First, a short overview over the research methodology is provided.

IV. Consulting Muslim Civil Society Representatives

The research presented here uses data from semi-structured depth interviews with Muslim community and opinion leaders in Germany. The overall purpose of the interviews was to explore attitudes and expectations of these representatives with regard to business ethics and corporate sustainability. One part of these interviews looked at ethical investment both in terms of what the organisations represented by the interviewees already practice in this field and which guiding principles and priorities they would apply if the organisation had (more) funds available for investment. For the analysis and partly also for sampling, a grounded theory inspired approach was used. The analysis consisted of focussed coding whereby the data was coded openly and close to the text, but with a focus on the respective interview question asked. Four questions will be used for this paper. The first question asked whether ethical investment was important at all to their organisation, the second looked at the perception of Islamic banks, the third asked about the main motivation for ethical investment and the forth question was directed at the methods the interviewees would prefer for their ethical investment.

Data from five interviews, each of which lasted around two hours, is considered in this paper. The participants were high ranking representatives of two representative bodies, one dedicated to a liberal stance of Islam, one understanding itself as the umbrella organisation for all Muslim organisations in Germany as well as two members of Sufi orders that take on official roles in their respective order. In addition, two representatives of Oikocredit (interviewed in one interview) also participated. According to its own website, “*Oikocredit is a worldwide cooperative and social investor, providing funding to the microfinance sector, fair trade organisations, cooperatives and small to medium enterprises*”.[2] Investors are both individuals and institutions, for example churches. The organisation has regional headquarters in investor countries and operational offices in those countries where the money is invested. They work with partner organisations such as microfinance institutes or cooperatives in those countries.

2 <http://www.oikocredit.coop/>

With the data being qualitative in nature, the research cannot claim to being representative and with it being also an explorative study, it does not intend to be so. Instead, exploring new grounds is the primary aim of this research and by using high ranking representatives of organisations as interview partners, it is hoped that the data will turn out to be of some significant. The reasoning behind this is that the interview partners mostly understood themselves as speaking not for themselves, but for the organisation and with all the organisations having a clear orientation towards Islam and promoting Islamic values (and spiritual development), it can be argued that the answers of the interviewees might be a good indication of the debate and way of thinking within Muslim communities.

Germany is an interesting field of study, because traditionally, ethical investment methods such as positive screening and best-in-class have played a much greater role than in other countries, although this picture has changed in recent years due to the high dynamics in the entire market (Eurosif, 2012: 39ff). Also, as a country, Germany has a reputation of engaging in the environmental agenda and fostering a fairly high level of environmental awareness among its population. Therefore, even though it does not play any significant role in Islamic finance at present, it might be seen as an interesting point of reference for the question posed in this paper.

Following the four interview questions, the following section looks at the data in detail and discusses the relevance of the results to the overarching question of what Islamic finance could learn from SRI, and more specifically from the grounding of SRI in a broader public debate driven by civil society.

V. Importance of Ethical Investment

The first question that shall be looked at is the question of whether ethical investment was deemed at all important to the representatives for their organisation. Here, most of the Muslim representatives thought that ethical investment was important to very important for their organisations for varying reasons. For the liberal representative, the importance of ethical investment was founded in the perception of money as means for political change and helping to raise awareness for positive examples of socially responsible projects and businesses. For the umbrella organisation, ethical investment has very concrete dimensions as it is actually involved in certifying both financial products as well as foodstuff for their *shariah*-compliance (the former in cooperation with external experts) and there had already been discussions of the application of a rating system to increase the differentiation between different products.

For one Sufi representative, ethical investment took shape only in the instructions of the sheikh to create a "*bait al mal*" (treasury) for the order that would collect the *zakat* and other charitable contributions of members and similarly support needy members. However, the other Sufi representative explained that ethical investment was extremely important for his order. Most financial management was dealt with through a foundation that has specific articles of association that define precisely how funds should be used.

It is interesting to observe that ethical investment seems to be important to the organisations interviewed and that some had indeed taken concrete steps in this direction. The results gain more important when read together with the next question, which looked at the perception of Islamic banks.

VI. Perception of Islamic Banks

One of the questions the interviewees were asked was whether they had ever considered dealing with Islamic banks in their financial transactions or whether they even had any experiences with Islamic banks.

In summary, the interviewees did not know much about Islamic banks or did not find the idea convincing at all. One of the participants highlighted that the term “Islamic bank” was contradictory per se, because the whole idea of Islamic finance is essentially about not earning money from money as banks do, but getting into business and as he said “*getting ones hands dirty*”. He also criticised that Islamic banks would use legal tricks. These statements gain significance, because his organisation has been involved in certifying Islamic financial products for German banks as mentioned above. But he himself expressed a certain degree of uneasiness with the sole division into *halal* and *haram* and acknowledged that it would be more desirable to have some form of rating system. For instance, he suggested that in such a rating, a cooperative would get a better grade than a publicly traded company with regards to ownership structure.

Another participant explained that his organisation, a Sufi order, has been dealing with a German social bank for many years. And that he felt that their way of doing business was in line with the order’s ethical requirements. He therefore did not see a need to look into Islamic finance. As part of doing business with this bank, the order actually holds cooperative shares of this bank, so it is quite closely associated with the bank. Interestingly, the reason why this participant felt that the bank was in line with the order’s own ethics was that they are very strong in supporting communities and collaborative projects. He suggested that this attitude towards supporting communities would be an important criterion for him in evaluating any business activity.

The other Sufi representative whose order has established a “*bait al mal*” rejected all banks as innovation that did not exist in the time of the prophet and he stated further that the idea of an Islamic bank was therefore a contradiction in itself.

The perception of Islamic banks among the representatives interviewed thus ranged from complete lack of knowledge to preference of a credible alternative to knowledgeable scepticism to outright rejection of the entire idea. In this context, it was especially interesting that the sceptical representative was the only one with some experience with the Islamic finance industry and that he would prefer creating a rating system for Islamic financial decisions rather than just deciding upon the question of *haram* or *halal*. It was also interesting to find out that social banks have been perceived by another interviewee as being credible and experienced with regard to the needs of communities and they can be seen as strong competition to Islamic banks. In fact, the data also showed that interviewees found it more important how a company acted rather than it claiming some sort of Islamic identity. Therefore, for the interviewees, Islamic banks would need to proof through their activities that they really acted in line with Islamic principles.

All in all, the findings, though not representative *per se*, could be seen as a clear warning to IBFs. They show that the discussion of form over substance is not just an academic exercise, but that also potential customers raise similar concerns. What is more, for the reasons explained previously, the interviewees can not only be viewed as potential customers, but also as potential facilitators for the idea of Islamic finance so their scepticism or lack of involvement should be seen as a major challenge to Islamic banks, especially as the market in Germany is largely untapped. With regard to the guiding research question, the conclusion could be drawn that a closer interaction of IBFs with civil society actors could help them to understand why people do not use their services and what it might need to reach out to a larger customer base. It could also be used to initiate internal processes towards diversification of their product base or to stay in the jargon to add substance to their activities. The following questions will help to deepen the understanding of what civil society actors expect from ethical investment and which role IBFs could play here.

VII. Motivation for Investment Decisions

The next question concerned the motivation for investment decisions and asked whether ethical or financial criteria would be more important for the investment decisions. The Sufi representative rejecting all Islamic banks and financial institutions outright was not asked these questions, because he generally emphasised the withdrawal from the world on the Sufi path, away from all economic activities.

As was explained previously, there are different patterns of motivation defined by Kurtz (2009) as value-based, value-seeking and value-enhancing. A forth category, suggested to be called value-defining was added here. From the descriptions of the Islamic financial industry given above, it could be concluded that the current actors move somewhere between the value-based and value-seeking motivations.

Among the three Muslim representatives who did answer this question, there was a general agreement that financial profit from investment is acceptable and desirable as long as it does not violate certain ethical foundations.

The liberal representative explained that for him, a profit would be acceptable if an investment would increase the general wellbeing and do only good.

The representative of the umbrella organisation also emphasised that the ethics would be the most important aspect. He generally took a more pragmatic stance, highlighting that wealth and financial profit are not forbidden in Islam and even high profits were acceptable as long as they were balanced through the giving of *zakat*. But he also admitted that personally he would think that a high profit is hardly ever possible without ethical drawbacks.

The Muslim interviewees motivations could be mainly described as value-based with one possibly leaning towards value-defining (an investment should work towards the general wellbeing and do only good).

It will be interesting here to contrast these answers with the input of the Oikocredit representatives. The interviewees explained that they found it important that investors had in recent years had returns of around 2% and that they were not only doing charitable work. But they also stated that the focus of the work of Oikocredit lies on the social return of the investment. Here, the idea of social return is introduced, which points towards a value-defining approach of the organisation. It is quite telling that the notion of social return did not occur to any of the Muslim interview partners. The idea of impact investment, which is the method mainly associated with this idea has only gained ground recently in SRI (Eurosif, 2012). It can be seen as the method that most strongly questions the existing economic system as it measures success not in financial terms, but in real impact on communities and the environment. Therefore, if ground should be gained on the debate form over substance, impact investment and the idea of social return would be a good starting point. Here, also the Islamic finance and economics research community might play an important role in exploring this issue further, breaking it down to the specific Islamic context.

VIII. Preferred Method of Ethical Investment

The final question analysed in this paper concerned the question of which methods the interviewees would prefer for their ethical investment. Each of the methods defined above were briefly explained during the interview.

Here, the answers varied somewhat. For instance, the liberal representative stated that positive and negative screening together could be used to invest in exemplary businesses, but that he thought that impact investment, especially investing in microfinance would be his most preferred method of ethical investment. This was also the preferred method for the Sufi representative (again, only one was asked, because the other had made clear, that only the order's own bait al mal would be considered appropriate. As the concept was understood to be based on charitable contributions only, it cannot be considered as ethical investment). The representative of the umbrella organisation stated that some form of positive screening would serve their purposes well and that care should be taken not to have too strict of a catalogue as Islam only forbids what is necessary.

The Oikocredit representatives explained their business model in more detail here, stating that the organisation gives both credits and equity based support to agricultural cooperatives and micro-finance organisations, sometimes also to family businesses in developing countries who otherwise do not have access to financial support. The organisation has defined five criteria that guide their investment decisions: Economic viability of project / business, foreign investment must be necessary (i.e. no provisions from local banks possible), consideration of environmental protection, involving women in decision-making processes, and the funded organisations must have functioning bookkeeping / accounting. In addition, Oikocredit is using a so-called ESG scorecard (environmental, social and governance). According to its website, further selection criteria are creation of jobs and income for disadvantaged people, and respect of animal welfare as well as excluding partners that are involved in activities including child labour, arms productions, explosives or other dangerous materials.[3]

The answers in this section show that there might be a market for business models such as that of Oikocredit within an Islamic context. This is in line with Asutay's (2007) suggestion of creating new Islamic financial institutions that are more socially oriented. The findings might be therefore encouraging for such institutions or entrepreneurs considering such a route. But it may also again be food for thought for 'conventional' IBFs to rethink their business model and especially consider taking up a greater range of methods used in developing financial products as both positive screening and impact investment are largely unknown or unused in the industry.

VX. Conclusion

The research question of this paper asks what Islamic banks can learn from socially responsible investment. To find an answer to this question, Muslim civil society actors were interviewed on a number of topics including ethical investment. The interviews showed that Islamic banks and financial institutions do not seem to be very well equipped with meeting the high ethical expectations, Muslims not necessarily very familiar with the industry articulate when asked in detail about various aspects of ethical investment. The most striking results of the interviews are the great deal of scepticism or lack of involvement with the Islamic finance industry even among Muslim 'representatives' and the positive resonance for methods currently not applied in the industry such as impact investment and positive screening.

The data suggest that Islamic banks can learn from engaging with civil society actors such as Muslim representative organisations or charities and in a way follow the footsteps of

3 <http://www.oikocredit.coop/partner-selection>

SRI, which was also greatly influenced by civil society. IBFs could learn what the Muslim community expects from a bank claiming to be Islamic. Islamic banks could for example enter into stakeholder dialogues or set up ethical advisory boards. This way they could counter the perceived lack of substance and add ethical depth and credibility to their activities as well as pave the way to new customer groups that care as much or more about the ethics of an investment than just the financial return. It would be an important realisation for the entire industry that high growth rates are not an aim in itself. In fact, possibly these high growth rates are themselves an indication for the lack of strong ethical goalposts as suggested by some of the interviewees who said that high returns would not be possible without ethical drawbacks.

Possibly, Islamic banks underestimate people's willingness to do good. In fact, there are examples of well-functioning organisations in the field of socially responsible investment such as Oikocredit that manage to "do well by doing good". This organisation, which has roots and still a strong footing within the Christian community, might be an exemplary organisation that could be created within a Muslim context. Essentially, it is a tool of channelling money from the affluent to the poor across continents, but not in the form of charity, but as an investment and with some basic ethical criteria attached to the selection process.

This idea would have to be explored further as generally more research needs to be done to further understand the position of the Islamic finance industry with regards to the challenges proposed by the findings introduced in the present paper.

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