
Tools for Risk Management in Islamic Finance: A Case Study of the “*Harm and Retaliation by Harm is not Allowed*” Sharī‘ah Maxim

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Abstract

Tracing through the pages of history, it becomes apparent that ‘risk’ in the field of finance was always there, and the measures to control it or to minimize it and/or to get rid-off from it were also taken. Thus, it is not an alien concept today. Speaking from the Islamic point of view, the Islamic primary sources holy Quran and Prophetic Traditions provide guidelines on the risk management. This paper, in this direction, is a humble attempt to throw light on the management of risk in Islamic finance in the light of Sharī‘ah Maxim the “redress of harm”. Harm has not been given any space in Islam either as initiative or in response. The measures taken in this direction and the rules deduced from this maxim to cover the risk has been highlighted. While risk is an important tool which is being focused before going to any financial transaction, this paper highlights how this maxim provides relief to minimize risk in Islamic financial sector, and gives the satisfaction to Islamic financial sector, application of the maxim in Islamic financial sector. Rules for redress of harm laid down by jurists have been also discussed.

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1. Introduction:

Islamic finance is a new phenomenon and this industry is growing at modest rate in different regions of the world not only in Muslim countries but also in Non-Muslim countries.³ Islamic Banking is *Sharī'ah* based financing mechanism which is different from the conventional financing tools. The products of Islamic financial institutions are absolutely different from the conventional modes of financing. Due to this reason the IFI's are facing unique risks associated to their products.⁴ The conventional as well as Islamic banks are subject to a wide range of risks in the course of their operations. In general banking risk falls into four categories: financial risk, operational risk, business risk and event risk⁵. There are different methods of risk mitigation in financial transactions.

The available literature discussed the risk in Islamic financial institutions and how these risks can be manage. On the other hand the contemporary *Sharī'ah* schoalrs have discussed Islamic law and *Sharī'ah* maxims in general. This study will focus the risk management in the light of *Sharī'ah* maxim "Harm and Retaliation by Harm is not Allowed". This study is theoretical in nature. Islamic financial Institutions face a unique mix of risks and risk-sharing arrangements resulting from the contractual design of instruments based on the principles of *Sharī'ah*, liquidity infrastructure, and the overall legal governance.

2. Islamic Finance Products and Associated Risks

2.1. Definition of Risk

Risk has always been major concern for banks as well as financial institutions; such institutions are always in search to adopt the practical as well as applicable methods for measurement of risk. Risk can be defined as "*any potential, incident, occurrence or any happening which may result to any physical social or economic loss.*" Or "*a situation involving exposure to*

³Muhammad Asghar Shahzad and Abdul Hameed, 'Islamic Banking Branches of Conventional Banks: An Analytical Review', *Pakistan Journal of Islamic Research* 19, no. 2 (2018): 43–65.

⁴Asim Ehsan et al., 'Compliance of Financial Statements of Islamic Banks of Pakistan with AAOIFI Guidelines in General Presentation and Disclosure', *SEISENSE Journal of Management* 2, no. 1 (2018): 12–21, <https://doi.org/10.33215/sjom.v2i1.53>.

⁵Amr Mohamed El Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability* (Hoboken: Jhon Wiley & Sons Inc, Hoboken, New Jersey, n.d.).

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danger. “In finance it can be generally defined any chance or uncertainty which individual or institution may have to face in the form of different returns or some loss then the expectations. From the dawn of history of mankind, man has always tried to be at safe position whether he was in search of shelter, food or anything else. His main objective was to have a safe life with peace and prosperity. To achieve his objectives he adopts new techniques and phenomenon and methods of all field of life. Simultaneously in his economic activities his endeavor was to avoid any uncertainty or future loss. However when economics has emerged as a well-defined and organized field of study for the benefit of mankind, different economists as well as financial experts has developed such fields because of the objective of being at safe position. Their primary aim was to measure the risk in order to monitor and control the risk. With this risk management became an important field in financial institutions.

2.2. Types of Risk

The global financial crisis raises the threat of inadequacy in financial regulation as well as in banking sector too. More alarming situation is that as we are moving towards forward developments in all sectors using modern techniques tools and methods more issues and crises arises. It is a fact that as we adopted more sophisticated and developed modern facilities, we are more prone more risks and crises. Some time in general first disease/crises/emergencies are being launched in the market then there treatment/management and substance are being taken into consideration particularly in the field of medical science, same during sometimes in financial institutions too.

Scholars have always made counter attacks to these emerging situations in all fields also in financial institutions as well. “Risks are usually defined by the adverse impact on profitability of several distinct sources of uncertainty. The financial risks can be elaborated in different types which are being discussed below. Risk measurement requires that both the uncertainty and its potential adverse effect on profitability are captured. Profitability refers, in the following, to both accounting and market-to-market measures.”⁶

Figure 01: Risk Faced by Banking Industry

⁶Bessis, Joel. *Risk Management in Banking*. Baffins Lane, Chichester west Sussex, England: John Wiley & Sons Ltd, 1998. P. 5

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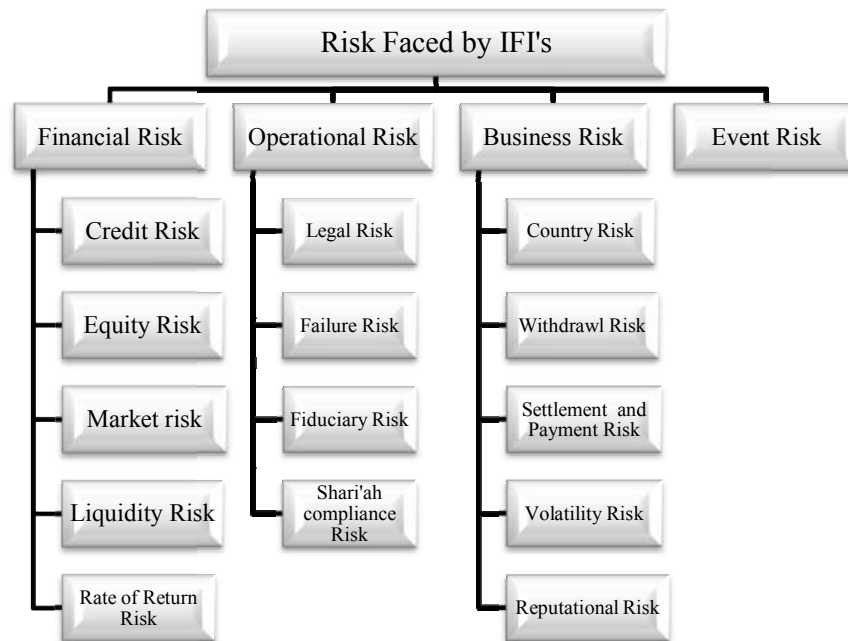
Islamic financial institutions are no longer safe on the above mentioned risks, however *Sharī'ah* had make major guidelines for the management of risk as well as scholars associated with Islamic finance had elaborated the subject within the boundaries of *Sharī'ah* and had derived concepts from the basic sources to either minimize or manage the risk in order to present the Islamic financial industry an alternative system by facing the challenges within the dogmas of *Sharī'ah*. It is really a great development from the *Sharī'ah* as well as Muslim financial experts that they have developed IFI according to need of the Muslims within *Sharī'ah*, still a lot of work has to be done in this field

3. Risk Faced by Islamic Banks:

“Islamic financial institutions face two types of risk while accompanying their operations, which include risks similar to conventional banks and unique and specific risks that arise due to particular requirements necessary to comply with *Sharī'ah* principles. In general risk associated with banks both conventional as well as in Islamic banks fall into main four categories; financial, operational, business, and event risk which are further divided into sub categories.”⁷ The Islamic banks are mostly based on *Sharī'ah* based financial mode therefore they also face some unique risks. Risks related to IFI products are discussed below:

⁷Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability*.

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4. Financial Risk:

Financial risks are those which are related to the financial loss to the institutions liabilities asset. All the financial institutions are exposed to such risk and Islamic ones are also exposed to equity risks too. All the risks which fall under this category:

4.1. Credit Risk:

Credit risk is Potential that counterparty fails to meet its obligations in accordance with the agreed terms. Credit risk is associated with specific features of Islamic financing contracts and also applicable on profit sharing assets (Musharaka and Modarba). It also includes the risk arising in the settlement and clearing of the transactions it is present in almost all of the instruments to varying degrees.⁸ Credit risk is one of the important risks in Islamic and conventional banks and is the major reason for the failure of banks.⁹

4.2. Liquidity Risk

Liquidity risk is the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall,

⁸Zamir Iqbal and Abbas Mirakhor, *An Introduction to Islamic Finance*: Theory and Practice (Singapore: John Wiley & Sons (Asia) Pte. Ltd, 1 Fusionopolis Walk, #07-01, Solaris South Tower, Singapore 138628, 2008).

⁹Iqbal and Mirakhor.

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without incurring unacceptable cost or losses.¹⁰ In other words extreme illiquidity, the safety cushion provided by the portfolio of liquid assets, or the ability to raise funds at a normal cost. Extreme illiquidity results in bankruptcy.¹¹

4.3. Market Risk

It is stated as the risk of losses in on-and-off balance sheet arises due to unfavorable price movements. Islamic financial industry is more exposed to market risk due to the volatility in the values of tradable, marketable and leasable assets.¹²“Market risk is defined risk of losses in balance sheet arising from fluctuations in prices of assets.”¹³

4.4. Equity Investment Risk

As the Islamic Banks are involved in the equity based investments, mostly in *Musharaka & Mudaraba*,¹⁴ in such case Islamic banks are more exposed to equity investment risk. On the other hand the conventional banks don't enter such transactions. This risk arises as the result of holding of equity for the purpose of investment or trading or liquidity purposes which are dealt with under market risks.

4.5. Rate of Return Risk

Rate of return risk is associated with PLS deposit holders in which they are not paid at announced expected rate of return. This causes depositors to withdraw their investments due to low rate of return as was expected. IBI waive off their own share and transfer it to depositors so to retain them with bank.

5. Operational Risk

Operational risks could be defined as the risk which may result from the inefficiency inadequate internal process, because of management or due to external incidents. This includes legal risk, fiduciary risk and *Sharī'ah* risk, which are discussed here as following:

5.1. Legal Risk

Islamic Banking industry faces more legal risk than conventional banks, due to nature and premature stages of Islamic commercial transactions

¹⁰Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability*.

¹¹Bessis, Joel. *Risk Management in Banking*.

¹²Iqbal and Mirakhor, *An Introduction to Islamic Finance □: Theory and Practice*.

¹³IBD SBP, 'Risk Management Guidelines for Islamic Banking Institutions', State Bank of Pakistan (Karachi, 2008), www.sbp.org.pk.

¹⁴Muhammad Asghar Shahzad, 'Book Review: Mudarbat in the Light of Sharī'Ah', *AFKĀR Research Journal of Islamic Studies* 3, no. 2 (2019): 4. <https://ssrn.com/abstract=3412035>

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which are derived from *Sharī'ah*. The major concern with this regards is the issue of enforceability. Whether *Sharī'ah* based contracts are legally enforced in case of legal dispute is a matter of concern.

5.2. Fiduciary and Failure Risk

Fiduciary risk is the risk that arises from Islamic bank's failure to perform in accordance with explicit and implicit standards, applicable to their fiduciary responsibilities. Therefore, a failure in maintaining fiduciary responsibilities will result in the deterioration of Islamic bank's reputation. It may lead to the legal action if the institution breaches the responsibilities. Islamic banks have to act up to the expectation of its investors/depositors, if there is any divergence in the objectives of clients, institution will face fiduciary risk.

5.3. Sharī'ah Compliance Risk

Sharī'ah risk is related to the structure and functioning of the *Sharī'ah* board at institutional and systemic level, to the potential non-compliance with *Sharī'ah* rules and principles in the banks operation, or the risk associated with contracts and the possibility of misconduct. It has been suggested by some *Sharī'ah* scholars that if a bank fails to act in accordance with the *Sharī'ah* rules, the transaction should be considered null and void from the *Sharī'ah* point of view and any income derived from it should not be included in the profits to be distributed to the investor's/depositors.¹⁵

6. Business Risk

Business risk is an important type of risk which is concerned with the business environment of a bank. This risk is affected due to macroeconomics, policy making, and law and regulation factors in the products of an Islamic financial institution. This includes the following types of risks

6.1. Country Risk

Country risk, results from potential instability of foreign assets due to political or financial events in a particular country. Islamic financial institutions normally import assets. This risk may arise in case of political instability of a particular country.

6.2. Withdrawal Risk

The withdrawal risk is a risk where bank face with large withdrawals by their depositors. This risk may arise due to loss of trust, conflict in the bank and higher rate of return offer by other banks. For mitigation of this risk the

¹⁵Iqbal and Mirakhor, *An Introduction to Islamic Finance*: Theory and Practice.

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IFI should increase their efficiency, and offer market competitive rate of return. This risk is also associated with reputational risk.

6.3. Settlement and Prepayment Risk

Settlement risk is a risk in which counterparty fails to continue the contract according to terms and conditions of the contract signed at the time of contract. On the other hand Repayment risk is that risk when the creditor pays the debt before the due date mostly in cases of mortgage loans because of interest rate.

6.4. Volatility Risk

This Islamic financial institution also deals with international trade which is being held in different currencies. There is always fluctuation in the exchange rate. This fluctuation can result in volatility risk in Islamic finance industry.

6.5. Reputational Risk

Reputational risk arises due to poor corporate governance in IFI. In this risk the trust of clients decreases because of irresponsible action and misbehavior of management. The loss of trust may lay to negative effect of the financial institution. This risk mostly arises in Islamic banks because of inconsistency in standards and practice among different Islamic banks in different jurisdictions and interpretation of *Sharī'ah* rules and principles. This risk has direct relation with *Sharī'ah* compliance risk.¹⁶

7. Event risk

Event includes all types of exogenous risks that could jeopardize the bank's operations or undermine its financial condition and capital adequacy, such risk includes political events, contagion due to the failure of a major bank or a market crash, banking crises, natural disasters, and civil wars. This risk is unpredictable, and in most cases, unexpected until immediately before the event occurs. Banks therefore, need to maintain a cushion of capital to prepare for this type of risk.¹⁷

7.1. Sharī'ah Maxims

Islamic legal maxims or *Sharī'ah* maxims or *Qawaid Fiqhiyyah* in Islamic jurisprudence have an important status. The whole literature based on legal maxims which have been mostly organized during 13th to 15th century with an object to extract laws from the from all *fiqh* literature in a summarized form in order to facilitate both students jurists so that understanding of Islamic

¹⁶Tiby, *Islamic Banking: How to Manage Risk and Improve Profitability*.

¹⁷Tiby.

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legal thought will be available for all groups of the society. The legal maxims are the statements formulated in precise legal form and depict a general picture, spirit, philosophy of Islamic law¹⁸.

7.2. Definition of *Sharī'ah* Maxims

Different *Sharī'ah* scholars have defined the *Sharī'ah* Maxims according to their understanding, the objective of *Sharī'ah* maxims derived from the primary sources as follows;

The renowned modern Muslim jurist *Sheikh Mustafa Ahmed Al-Zarqa* defined the *Sharī'ah* Maxim in following words,

*“Universal principles of fiqh formulated in a concise legal form, embodying broad general rulings in cases that fall under their subject”*¹⁹

Another Muslim jurist Ali Hyder, defined it as,

*“The comprehensive or pre-dominant rule which is sought in order to know its particulars”*²⁰

From the above mentioned definitions it is clear that the legal maxims are general principals derived from primary sources of *Sharī'ah*, where from these general principals we can apply the *Sharī'ah* rulings on the specific cases. It is also clear that the main objectives of legal maxims are to facilitate both Muslim jurists as well as general masses, so that everyone will be able to know the basic concepts of Islamic Law.

7.3. *Sharī'ah* Maxims relevant to Islamic Finance

From the dawn of 20th century with the emergence of Islamic economics in general and later on Islamic finance in particularly as an alternative system of the conventional economics and financial system. The Muslims scholars have developed great endeavor to develop the Islamic economics and finance within the context of *Sharī'ah*. Simultaneously they developed all legal thought of Islam in order to make them relevant to Islamic economics and finance, similarly they have developed Islamic legal maxims, to deduce the rulings from it to make Islamic finance relevant to contemporary world according to the need of *ummah*. Islamic legal maxims provide a great platform to face the contemporary challenges faced by Islamic finance to

¹⁸Dr. Muhammad Tahir Mansoori, *Shariah Maxims: Modern Applications in Islamic Finance*, *Shariah Academy*, 2nd ed. (Islamabad, Pakistan: Sharī'ah Academy, International Islamic University, Islamabad, 2012).

¹⁹Dr. Muhammad Tahir Mansoori. p2

²⁰Dr. Muhammad Tahir Mansoori.

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present the solutions of such challenges. There are number of legal maxims relevant to Islamic finance upon which different scholars have pen down their writings. The development of Islamic financial system raised many contemporary issues in Islamic commercial contracts. These issues are needed to resolve in according to *Sharī'ah*, most of the time we cannot find direct ruling from the basic sources of *Sharī'ah*. Hence the legal maxims would provide solution to develop parameters and principals in general. Legal maxims also provide tools for risk management in Islamic finance. The objective of *Sharī'ah* is to secure public interest and to provide social, economic security as well as prosperity of its followers. The application of legal maxims for risk management in Islamic finance is discussed in detail as follow.

7.4. *Sharī'ah* Maxim La DararWalaDidar(لا ضرر ولا ضرار)

This is one of the famous *Sharī'ah* maxims also among the basic ones. This maxim has been derived from the famous hadith of the Prophet (SWA); According to Hazrat Abadath Ibn E Samit (RA) the Prophet (harm and retaliation by harm is not allowed).²¹ This hadith has been mentioned by *many muhaditteens* and many scholars in their writings differently which are illustrated as:

“Harm is not allowed, whether as an initiative, nor in response.”

“No harm should be caused, and none should be suffered”²²

The main objective of this maxim is that harm in anyway should be eliminated or redressed. It is precautionary measure for any future untoward incident or occurrence which may result any harm to any particular issue.

The application of this maxim in Islamic finance as a tool for risk management, this maxim has vast application on different issues faced by IFI in redressing the harm in them, which are being discussed here

7.5. Law of Inhibition(*Hajr*)

Islamic legal setup can restrict some-ones activity which may be harmful for other. The law of inhibition is one of the tool for restrictions, the act of preventing someone in making contracts is called *hajr*, by which a person can be prevented to dispose his property at his will without caring the rights of others from his property. The law of inhibition is prescribed in *Sharī'ah* to safeguard the rights and interest of the people on whom it is

²¹Abū Abdillāh Muhammad ibn Yazīd Ibn Mājah, *SunanIbneMaja*, (Lahore, Pakistan: Darul Salam International, Lahore) Hadith No. 2340, Page. 428

²²Dr. Muhammad Tahir Mansoori, *Shariah Maxims: Modern Applications in Islamic Finance*.

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imposed, as well as rights and interests of people who may be affected by the dispositions of a particular category of persons.²³ This law is applicable on various issues such as in the case of prodigality, death-illness and insolvency, which if properly elaborated and discussed can become tools for risk management in IFI.

7.6. Law of pre-emption(*Shuf'ah*):

Shuf'ah is Arabic word which means merging, adding, strengthening. Technically, it is the right to compel the buyer of immovable property to transfer the ownership to the claimant on the terms and conditions on which he bought it. This right belongs to the co-owner as well as the neighbor according to the Hanafis.²⁴

This law has been granted mostly by four major Sunni schools to the immovable property only and the *zahiris* consider it for movable property too. The objective of this law is to prevent any harm which may occur to the co-owners or neighbor's, if sold by owner to the third party without the consent of co-owners or neighbor. This law can be applicable for the risk management in Islamic capital markets by make bidding on the shareholders so that they can't sell shares to the other party without the consent of other shareholders.

7.7. Law of Continuation of crop-sharing contract till harvesting:

According to the *Shari'ah* scholars the contract which has finished due to any element of termination but the object of the contract is still in process the contract will continue till the object of the contract is attained. In *muzara'ah* contract in case the tenant has died and the crop is growing and not yet harvested. The Muslim jurists are of the view to remove hardship the contract of *muzara'ah* should continue till harvesting. This law can be applicable in *Ijarah*, *Istisna* and *Salam* contract by Islamic financial institutions for the risk management by putting the clause in contract.

7.8. Liability of Crafts Man:

In Islamic law the *ajeer e mushtrikis* consider as *amen* and *amen* is not liable for any damage or loss of the subject matter of *mustaajir*. So for as crafts man and trades men are concerned such as tailor, goldsmith. Muslim jurists are in the opinion that they (crafts man) are liable to the subject matter which are in their custody on account of their negligence. If their negligence is

²³Dr. Muhammad Tahir Mansoori.

²⁴Imran Ahsan Khan Nyazee, *Outlines of Islamic Jurisprudence, Federal Law House* (Rawalpindi Pakistan: Federal Law House, Main Plaza, Chandni Chowk, Rawalpindi Pakistan, 2005); Dr. Muhammad Tahir Mansoori, *Shariah Maxims: Modern Applications in Islamic Finance*.

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not proved the crafts man is not liable. This law is applicable in Islamic financial institutions for the risk management in the cases of those products which are being kept as trust in the institution. For the interest of general people this law has been formulated to manage their risk. In the participatory account of depositors and banks investment on the basis of profit and loss account are also in the ambit of this rule.

7.9. Penalty for Defaulter:

A debtor who does not pay the liability even if he is capable to pay is strictly detested by *Sharī'ah*. In conventional banking system the bank charge penalty due to late payment. But this amount is not allowed in *Sharī'ah*. In Islamic financial institutions they can't charge penalty from their clients due to late payment. Infact this is case of harm to reduce this, contemporary Muslim jurists came with a solution that Islamic financial institution if finds a person guilty and can impose some penalty which will be paid compulsory to the charity fund. The IFI will not use the amount of charity or not pensive as income. This amount of charity will be used only for the purpose of charity. OIC Fiqh academy and AAOIFI have also made their resolutions on this issue. The IIFA first in its judgment in 1990 rejected such proposal; later on they accepted this resolution in 2000, that IFI can include this in their clause. Similarly AAOIFI have made the resolution standard No.8 Murabaha to the purchaser order as under

*“It is permissible that the contract of Murabaha consist of an undertaking from the customer to pay an amount of money or a percentage of the debt, to be donated to charitable causes in the event of a delay on his part in paying installments on their due date. The Sharī'ah supervisory board of the institution must have full knowledge that any such amount is indeed spent on charitable causes and not for the benefit of the institution itself”.*²⁵

7.10. Sub Maxims of La Darar Wala Dirar and their implication in Risk Management

All the maxims which are related to the above mentioned maxim such as harm has to be reduced, a greater harm may be avoided by enduring a lesser harm, specific harm may be borne to prevent public harm, repelling evil super

²⁵AAOIFI, *Sharia'ah Standards, for Islamic Financial Institutions* (Manama, Bahrain: Accounting and Auditing Organisation for Islamic Financial Institutions, P.O. Box 1176, Manama, Bahrain, 2017); Dr. Muhammad Tahir Mansoori, *Shariah Maxims: Modern Applications in Islamic Finance*.

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cedes securing benefits and harm cannot compensate harm. All these maxims provide different tools which have application in redressing the harm in Islamic finance. If properly studied and elaborated according to the *Sharī'ah* point of view they can guide us in management the risk in Islamic finance. The cases like force majeure, illegal positions option of defect, case of fraudulenceprevention of public harm, price fixation, taxation and hording can be addressed in the light of above maxims.

8. Conclusion and Findings:

Islamic Banking and finance is an alternative to the conventional set-up of financial sector. From its emergence since 1970's onwards, lot of work has been penned down by high-brow Muslim intellectuals of this field. Still t is going on and lot has to be done yet, as it has not achieved the ultimate goal which at least should be that all Islamic states should be free from interest based conventional banking. To achieve this object intellectual efforts and scholarly work of practicable nature in this field has tofill gap in order to face the modern technical and emerging challenges faced by Muslims all over the world. Among the different challenges risk and its management is one of essential challenges faced by IFI. The global financial crisis which occurred in 2007 has also influenced the Islamic finance industry too. As Islamic finance is based on *Sharī'ah* rulings therefore all challenged has to be addressed within the *Sharī'ah* point of view. IFI also faces some unique risks which are not in conventional finance. Now it is the need of hour to expose the risk in Islamic finance and check it also manages the risk according to *Sharī'ah*. Lot of literature has been written on this subject. So far as Islamic legal maxims which are one the important subject also guides in finance sector too. Legal maxims and their application in Islamic finance as well as in risk management have to be developed a lot. Legal maxims provide us the platform for facing the emerging challenges in general principles. The maxim "*harm and retaliation by harm is not allowed,*" is an important tool for risk mitigation in Islamic finance as it has been discussed above. This rule redresses the harm which may occurs in future. There is a lot of space for researchers to fill this gape in this area.

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