

Issues on Islamic Banks' Nostro Accounts

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Abstract

All Islamic banks in Malaysia which involve with the international trade transaction will have to have a Nostro accounts with a conventional correspondent/agent banks in order to make payments through them. The objective of this study is to clarify the issue on the usage of Nostro accounts in conventional banks by the Islamic banks where these accounts deal with *riba* (interest) in their daily transactions from the Shariah perspective. This study adopts the qualitative method as the main research methodology. The information on the involvement of 12 Islamic banks in Malaysia with Nostro accounts in conventional banks is gained from semi-structured interviews conducted with bankers who directly involved with international trade payments. As a result, this study discovered two main issues. First is the issue on the permissibility of the involvement of the Islamic banks with the Nostro accounts. While the second issue is the tendency of some Islamic banks leverage on the conventional parents' banks Nostro accounts. This study analyzes these issues by determining whether they are in line with Shariah principles.

Keywords: *Issues, Islamic banks, Nostro accounts, Shariah perspective*

1. INTRODUCTION

In the financial payment and trade settlement systems, the banks play a very crucial intermediary role locally and internationally. The landscape of payments technology within any bank is often very complex, with aging legacy solutions, fragmented by payment type, currency, clearing mechanism, and etc (Bareisis, 2011). For example, in the normal international scenario, a buyer or importer from Malaysia who involves in the international trade with a seller or exporter in the United States will instruct his banker in Malaysian bank to make payment to the seller. In order to make payment to the seller, the Malaysian bank will instruct its correspondent/agent bank in the United States to make payment by Society for Worldwide Interbank Financial Telecommunication (SWIFT) or telex occasionally (Pang, 2000). It is the practice of the Malaysian banks to keep an account which is known as Nostro account with the correspondent/agent banks. By definition Nostro account is an account maintained by a bank with a bank in a foreign country and it is kept in foreign currencies of the country in which the monies are held, with the equivalent dollar value listed in another column (Rosenberg, 1994 and Bollen, 2007). On the contrary, a Vostro account holds foreign currency on hand (Bollen, 2007). These Nostro and Vostro accounts are used to manage foreign exchange transactions (Gipson, 1994). In this case, the United States (US) dollar account of the Malaysian bank maintains with its correspondent/agent bank in the US is known as a Nostro account. If in return the US correspondent/agent bank maintained an account in Malaysian Ringgit with the Malaysian bank, this account is known as Vostro account (Pang, 2000). However, this study focuses only on the usage of Nostro accounts by Islamic banks in the international trade payments.

All the Islamic banks claim that they do not involve with *riba* (interest) in their banking operations. However, in the case of international trade payments for trade transactions where payments have to be made in the US dollar, the Islamic bank has to have a Nostro account with a conventional correspondent/agent bank in order to make payments through it. Obviously, this Nostro account maintained by the Islamic bank is a non Shariah compliant account because it involves interest charges in its daily transactions. The issue on the Islamic banks involvement with a Nostro accounts has to be clarified from the Shariah point of view because there is a view of the Religious Supervisory Boards of one of the international Islamic banks that it is lawful or permissible to place money in the conventional correspondent/agent banks (Saeed, 1998).

Another Shariah issue on the Nostro account is the practice of some Islamic banks in Malaysia which are the subsidiaries of conventional parent banks that do not have their own Nostro accounts with the conventional correspondent/agent bank but still leverage on the parent banks' Nostro accounts. At the same time, there are other Islamic banks which have their own Nostro account with the conventional correspondent/agent banks without leveraging on the parent banks' Nostro accounts. The concern is on the mixture of the Islamic banks' money, which is *halal* (permitted by Shariah), with the parent banks' money which are *haram* (prohibited by Shariah) in the same Nostro accounts (Sarah, personal communication, 23 November 2009). This particular issue should also be discussed based on the Shariah point of view.

There is almost no previous study on the involvement of Islamic banks with Nostro accounts with the conventional correspondent/agent banks for this is a new area. Only Saeed (1998) touches on this matter indirectly while discussing on interbank mutual arrangement in his article. It is mentioned in his article that an Islamic bank is having interbank mutual arrangement with the correspondent/agent bank in order to avoid interest charge in the Nostro account. However, there are a plenty discussion on the relationship of banking with international trade and financing payment. For example, Pang (1988) discusses on the various banking services and facilities commonly available, in relation to the everyday banking needs and requirements of the man-in-the-street while extending to domestic and international trade finance for the businessmen, and clarifying also the nature of the relationship between the bank and the customer. Rosli (1994) on the other hand, explains on the operation of international trade from the conceptual, practice and financing perspective. He also explains on Nostro and 'Vostro' accounts function in the international trade. The discussion on both conventional and Islamic trade finance is done by Ismail (1997) which touches generally in the areas of the international trade terminology, the banking requirements for proper preparation of the shipping documents, payment procedures, international rules on collections and letters of credit, exchange control requirements and the financing of trade. However, no discussion on the issue of the usage of Nostro accounts in doing international trade payment or settlement.

Fauzias (2004) discusses on the fundamental concept of international finance. It also provides a complete range of topics in international finance such as the history of international exchange rate system and Malaysian foreign exchange market, Malaysian international banking and international financial centre and methods of payment in international trade. Rodney et. al (2004) discuss about international trade and Gulf Co-operation Council (GCC) economic relations. However, no issue of Islamic Nostro accounts is discussed. Thus, the objective of this study is to clarify the issue on the usage of Nostro accounts in conventional banks by the Islamic banks where these accounts deal with *riba* in their daily transactions from the Shariah perspective.

2. RESEARCH METHODOLOGY

Qualitative methodology is adopted for this research. Both the primary and the secondary data are used for the purpose of this research. The interview method for data collection is very crucial in this research mainly because the primary data regarding the involvement of 12 Islamic banks in Malaysia with Nostro accounts in the correspondent/agent banks is gained through the method of interviews with selected respondents who are directly involved with international trade payments.

The semi standardized (guided-semi structured or focused) face to face interview has been selected as the main method of collecting extensive data on the involvement of 12 Islamic banks with Nostro accounts in the correspondent/agent banks with all the respondents as an alternative way to obtain information due to the lack of published materials in the mentioned issues of Nostro accounts. Twelve interviews are conducted with respondents cum bankers from 12 Islamic banks that have given their full supports and been directly involved in this research. These Islamic banks are Affin Islamic Bank Berhad, Al Rajhi Banking & Investment Corporation (Malaysia) Berhad, Alliance Islamic Bank Berhad, Asian Finance Bank Berhad, Bank Islam Malaysia Berhad, Bank Muamalat Malaysia Berhad, CIMB Islamic Bank Berhad, HSBC Amanah Malaysia Berhad, Kuwait Finance House (Malaysia) Berhad, Maybank Islamic Berhad, RHB Islamic Bank Berhad and Standard Chartered Saadiq Berhad. Some of the respondents are willing to disclose their identities for this research while some of them preferred to remain anonymous. The researcher has also interviewed a few Shariah scholars such as Associate Professor Dr Shamsiah Mohamad from the Academy of Islamic Studies in University of Malaya, Prof. Dato Dr Mohd Azmi Omar the former Dean of Institute of Islamic Banking and Finance in International Islamic University and Dr. Ahsene Lahsasna from International Centre for Education in Islamic Finance in order to get their opinions on the involvement of the 12 Islamic banks with Nostro accounts in the conventional correspondent banks from the Shariah point of view.

The secondary data for this research was gathered through library works. Unfortunately, there are not so many books and articles written on the involvement of Islamic banks with Nostro accounts in conventional correspondent banks except for an article written by Saeed (1998). However, the information on Nostro accounts can be found in finance related books such as Pang (1988 & 2000), Rosli (1998) and Fauzias (2004) which has helped the researcher a lot in gaining information and understanding on this research. The major limitation in this research is the lack of published materials like books and journals on the issues of Islamic banks' Nostro accounts and thus this research relies heavily on the data and information gained during the interviews with the respondents.

The information on the involvement of the 12 Islamic banks with Nostro accounts in the conventional correspondent banks is identified from the interviews with the selected respondents and a few reading materials referred which are then classified into two main issues. The first issue is whether the usage of the Nostro account with the correspondent/agent bank by Islamic bank in international trade payment is permissible according to Shariah since it is a non Shariah compliant account that involves interest charges in its daily transactions. The second issue is the practice of some Islamic banks which are the subsidiaries of conventional parent banks in Malaysia that still leverage on the parent banks' Nostro accounts in the correspondent/agent banks. These two issues are elaborated and analyzed according to the situation or problem that the Islamic banks is facing and also according to the Shariah point of view. At the end of the research, the best practice of the Islamic banks when dealing with the Nostro accounts is determined and a few recommendations to Bank Negara Malaysia and the Islamic banks are given.

3. FINDINGS AND DISCUSSION

This part is very important to illustrate the two issues that arise in the involvement of the Islamic banks with the Nostro accounts with conventional correspondent/agent banks in international trade payments. Thus, the discussion under this sub-topic will be divided into two issues.

3.1 First issue

The Quran instructs Muslims not to acquire each other's property wrongfully in al-Baqarah: 188 which mean:

"And do not usurp one another's property by false means, nor offer it to the judges so that you may devour willfully and unjustly a portion of the property of the people..."

Thus, the right guidance to differentiate between *halal* and *haram* trade has been described in al-Nisa': 29 which mean (International Shari'ah Research Academy for Islamic Finance, 2011):

"O ye who believe! Eat not up your property among yourselves in vanities: But let there be amongst you traffic and trade by mutual goodwill: Nor kill (or destroy) yourselves; for verily Allah hath been to you Most merciful."

Acquiring other's property wrongfully includes the prohibition of *riba*, *gharar* (uncertainty) and *maysir* (gambling) in daily activities. *Riba* is condemned clearly in the Quran and the Sunnah leaving no room for doubt as to its prohibition (Securities Commission Malaysia, 2009). One of the verses which show the prohibition of *riba* can be found in surah al-Baqarah: 275 which mean:

"Those who devour usury will not stand except as one whom Satan has prostrated by his touch will stand. This is because they say, "Trading is like usury." But Allah has allowed trading and forbidden usury. So, whoever takes the admonition from his Lord and desists, he shall have his past gains and his matter is for Allah, but whoever reverts, those are the inhabitants of the Fire, to dwell there forever."

Thus, the first issue which is going to be discussed refers to Nostro account is in the case where the Islamic bank as the buyer/importer's bank may deal with *riba al-nasi'ah* (any unjustified increment in borrowing or lending money whether in kind or cash over and above the principal amount, as a condition stipulated or agreed between the parties (Securities Commission Malaysia, 2009) or interest charge when payment is to be made on behalf of the buyer/importer to the negotiating banks which is the seller/exporter's bank using the Nostro account in correspondent/agent bank in the seller/exporter country.

It is undeniable that Nostro account in conventional correspondent/agent bank is a non Shariah compliant account because *riba* is involved in its daily transactions. The Nostro accounts must be used by the Islamic banks in Malaysia to settle payment for their customers who involve with international trade and the trading are done in the US dollars. In international trade, there is a need for the Islamic banks in Malaysia to maintain an account with it correspondent/agent bank in the United States of America because normally the US dollar is the most preferred currency to be used (Ahmad Tarmizi Abu Hanifah, personal communication, 14 September 2009). When the Islamic bank is supposed to make payment to the negotiating bank which is the seller/exporter's bank designated in the US dollars, it will instruct its US correspondent/agent bank to make payment by debiting the US dollar accounts which is the Nostro accounts through SWIFT or by telex (Pang, 2000).

By using the Nostro account, the Islamic banks cannot claim that they are not involved in *riba* in their banking operation because there is a possibility where *riba* is sometimes being charged to the Islamic banks when their balance of money in their Nostro accounts with the correspondent/agent banks are insufficient. The argument will be on the *riba* or interest charge bearer. It is the practice of conventional banks to charge *riba* or interest to their customer but the Islamic banks are not permitted to do so. In this situation, usually the Islamic banks will have to absorb the cost derived from interest charges (Azlan Abd Samad, personal communication, 15 January, 2010). If this happens, the Islamic banks will have to explain to their Shariah committee the reason they have to involve with *riba* activities in some circumstances.

The second Shariah issue which arises in Islamic banks in maintaining Nostro account with the correspondent/agent banks is that their money placed in this Nostro account will be the opportunity cost for the Islamic banks in Malaysia. It is because Islamic banks will not get any return for the money because the dividends are paid by the conventional banks which are interest based and they are considered *haram*. However, Islamic banks have to leave a certain amount of their money in the correspondent/agent banks as a protection from interest charges in the circumstance where their balance is insufficient (Azlan Abd Samad, personal communication, 15 January, 2010) and also as a requirement from the correspondent/agent banks to open the Nostro account (Azahari Awang Ahmad, personal communication, 26 May, 2010).

It is undeniable that using the Nostro account with the correspondent/agent bank in international trade is a Shariah issue because the account is not a Shariah compliant account. However, the Shariah Advisory Council (SAC) of Central Bank of Malaysia or Bank Negara Malaysia (BNM) approved the usage of the Nostro accounts in international trade payments and settlements system among banks because of the needs of using these accounts (Shamsiah Mohamad, personal communication, 13 January 2010; Ahcene Lahsasna, personal communication, 7 May 2010; Mohd Azmi Omar, personal communication, 19 May 2010).

Islamic banks can never be involved in international trade if they do not have Nostro accounts with conventional correspondent/agent banks because most of international trade transactions are done in the US dollar currency. Therefore, to solve this issue and at the same time, to enable the Islamic banks to involve in international trade the concept of *hajiyyah* (the complementary) (Kamali, 2004) is invoked here. It is true that the Islamic banks will not collapse if they do not have this Nostro accounts but they can never be involved in international trade transactions if they do not have them. The involvement of Islamic bank in international trade is very crucial in order to be relevant in the banking industry. Furthermore, the Islamic Nostro account is not a common account established by banks in the world. In 2008, Lloyds TSB has launched a new bank account or the Islamic Nostro account and in 2010, Standard Chartered Bank announced its first Islamic US dollar Nostro account. However, according to Mokhlis Maizan (personal communication, 7 June 2012) most of the Islamic banks in Malaysia today are so complacent with the existing Nostro accounts that they have and having an Islamic Nostro account in the market will not affect their common practices. Moreover, these Islamic banks believe that they have their own ways to protect themselves from *riba* charges by involving in the Nostro accounts.

For the first Shariah issue raised above, the treasury department in Islamic banks plays a very important role to avoid the interest charges when the balance of money in their Nostro account with the correspondent/agent banks is insufficient. The treasury department has to manage or maintain the Islamic banks Nostro account with information given by trade and other departments. It means that every daily transaction involving international trade using

Nostro account by the trade department in Islamic bank must be reported to the treasury departments accurately used (Ahmad Tarmizi Abu Hanifah, personal communication, 14 September 2009). As for the second Shariah issue above, the Islamic banks will have to forego the dividend which is paid by the conventional correspondent/agent bank for their Nostro account because it is not *halal* income. All the incomes of the Islamic banks which are considered as non *halal* will be channeled to the charity purposes in the Muslim society in Malaysia and throughout the world (Peer Mohamed Ibramsha, 2012).

Islamic banks have to be very careful in using the Nostro account in international trade payment and transaction because the deals might involve *riba* in some circumstances. Thus, Islamic banks have to ensure that their systems are ready to prevent or protect themselves from *riba* or interest charges. BNM at the same time must consider suggesting to the correspondent/agent banks such as Bank of New York, Citibank of New York, Wachovia Bank and all the US banks which have not established Islamic Nostro accounts to initiate the move to cater the needs of Islamic banks from Malaysia and all over the world. Islamic banks are now the players in international trade and it is about time for the conventional banks to consider their needs to have Islamic Nostro accounts. At the same time, BNM must remind the Islamic banks in Malaysia to open an Islamic Nostro accounts with the banks which have established them.

3.2 Second issue

Some Islamic banks which are the subsidiaries of the conventional banks in Malaysia do not have their own Nostro account with the conventional correspondent/agent bank but they are leveraging on the conventional parent banks' Nostro accounts. This study has chosen the practice of seven Islamic banks involved in this study which are the subsidiaries to their conventional parent banks as can be seen in the Table 1 below. The issue is on the mixture of the Islamic bank's money which is *halal* with the conventional parent bank's money which is *haram* in the same Nostro account. From the Table 1 below, three out of the seven Islamic banks are leveraging on the conventional parent banks' Nostro accounts while four out of seven Islamic banks are using their own Nostro accounts which are separated from their conventional parent banks' accounts.

Table 1: Islamic Banks Nostro Accounts

No.	Name of the Islamic Banks	Using Own Nostro Account	Leverages on the Conventional Parent Bank's Nostro Account
1.	Affin Islamic Bank Berhad	Yes	No
2.	Alliance Islamic Bank Berhad	No	Yes
3.	CIMB Islamic Bank Berhadet al	Yes	No
4.	Maybank Islamic Berhad	No	Yes
5.	RHB Islamic Bank Berhad	Yes	No
6.	HSBC Amanah Malaysia Berhad	Yes	No
7.	Standard Chartered Saadiq Berhad	No	Yes

The main reason why some of the Islamic banks are still leveraging on the parent banks' Nostro accounts is because their Shariah Committee have given interim approval to address the usage of these accounts until such time when a more compliant account is established to facilitate Islamic international trade payments (Sara Shamsudin, personal communication, 23 November 2009). Therefore, there is no Shariah issue to ride on the conventional parent banks' Nostro accounts because it is only the operational matter (Ismail Mahayudin, personal communication, 10 May 2010).

One of the Islamic banks admitted that they are not only leveraging on the Nostro account but also in marketing the Islamic products at the bank using the marketing staff of the parent bank (Remained anonymous, personal communication, 22 June 2010). Furthermore, another Islamic bank claimed that it is using the conventional parent bank's account because its account is not ready or not opened yet. This is because the Islamic bank deals with a very big volume of international trade payment per day and it is related to infrastructure of the banking system and there is a constraint to open its own Nostro account. This Islamic bank has the opinion that the Islamic bank which has its own Nostro account because it deals with a small volume of international trade transaction per day and the transaction can be processed manually (Ahmad Tarmizi, personal communication, 14 September 2009).

Table 1 also shows that four out of seven Islamic banks are having their Nostro accounts separate from their parent banks. The main reason is because they believe that the Islamic funds and the conventional funds cannot be combined in one account (Ferdaus Toh Abdullah, personal communication, 25 May 2010). Furthermore, these banks believe that even if they cannot do the perfect Islamic banking at least they have the basic practice that is not to mix the Islamic banking funds with the conventional (Azahari Awang Ahmad, personal communication, 26 May, 2010). The other reason is the difficulty in differentiating profit given to the money placed in the Nostro account between the Islamic bank and its parent bank. If the Islamic bank's money placed in the parent bank's Nostro account received dividend or profit from the correspondent/agent bank, the dividend is considered as *riba* which is a dividend gained from the conventional bank's account. Apparently, the Islamic bank will not have control over the dividend.

The issue of Islamic banks that are still leveraging on the parent banks' Nostro accounts is depending on the opinion of the Shariah Committee of the Islamic banks as well as relying on the approval given by BNM for the Islamic banks to use the Nostro account of their parent banks. Separating the Islamic banking funds and the conventional banking funds would be the best practice because of the two different natures of businesses. Almighty Allah has made *halal* what is entirely beneficial and has declared *haram* as what in totality is harmful and hazardous for mankind (Sayed, 2006). The proof from the Quran is in surah al-A'raf: 157 which mean:

"Those who follow the Messenger, the unlettered Prophet, whom they find written of in their own Sriptures, the Torah and the Injeel, he enjoins on them what is good and forbids them from what is evil, and he makes the pure things lawful to them, and forbids them from the impure..."

Thus, mixing the *halal* and *haram* in one account is clearly prohibited in Islam (Ibn Nujaym, n.d.). Furthermore, the accounts should be separated because it is two separate entities and any dispute may arise in the future as the result of utilizing single account. Opening Nostro account involves huge costs but it depends on the Islamic bank's policy and the Shariah Committee to solve this problem.

It is merely the decision of the Shariah Committee of the Islamic banks to instruct their banks to separate the Nostro account with the parent banks which is the better practice (Ahcene Lahsasna, personal communication, 7 May 2010; Mohd Azmi Omar, personal communication, 19 May 2010). The Islamic banks will have to follow any decision made by their Shariah Committees. Without the instruction from the Shariah Committee to have a separate Nostro account with the parent's bank, the Islamic banks will have to initiate some protections from involving with *riba*. Nevertheless, the best solution in handling this issue is BNM as a regulator shall consider preparing a guideline to be a guidance of all Islamic banks in order to have standard practice.

4. CONCLUSIONS AND RECOMMENDATIONS

In conclusion, there is issue regarding the usage of the Nostro account in the case of international trade payment for Islamic banks in Malaysia. The main issue in the usage of Nostro account in international trade payment is the fact that it is a non Shariah compliant account where *riba* is involved in its daily transactions. By using the Nostro account in international trade payment, Islamic banks may involve in *riba* especially when the account is overdrawn where the balance is insufficient. Thus, in order to avoid interest charges, the treasury department in Islamic bank has to properly and accurately maintain daily balance of money in the Islamic banks Nostro account with information given by trade and other departments. BNM, which has the highest authority in banking industry, on the other hand, must consider suggesting to the international banks such as Bank of New York, Citibank of New York and Wachovia Bank to set up Islamic Nostro accounts to accommodate the need of Islamic banks from Malaysia and countries all over the world which are involved in international trade payment using the US dollars. As for the second issue which is about the practice of a few Islamic banks which are still leveraging on the conventional parent banks' Nostro accounts without having their own accounts, it is recommended that BNM must consider setting a rule that all Islamic banks should have their own Nostro accounts. The Islamic banking funds and the conventional banking funds should be separated because the *halal* and *haram* funds cannot be mixed together in one account. For the time being, the Shariah Committee of the Islamic banks must play a role in asking the Islamic banks to separate the Nostro account from the conventional parent banks because they have full authority in this matter. The Shariah Committee of the Islamic banks has to ensure that the Islamic banks have done some kind of protection for their banks to get involved with *riba* in their daily international trade transactions.

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