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Jakhongir Imamnazarov:

Conceptual Framework of Sustainability of Islamic Financial Institutions amid Global Financial and Economic Crisis

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Abstract

After the last global financial crisis, interest in the system of Islamic finance, which is one of most rapidly growing segments of the global financial system, has increased significantly. However, despite the growing importance of Islamic finance, unfortunately, full understanding and support from regulators, policy makers and practitioners are still lacking. This paper provides a brief review of the principles and practices of Islamic finance in the context of the recent global financial crisis, and can serve as an appropriate starting point for further work in the field of Islamic finance.

1. Introduction

Can an economy survive without creating bubbles? Economists of the Old and the New World are most likely to answer that the movement from crisis to crisis is the mainstream development of economic activity. However, in addition to the Western economic model, there is anothermodel, which contains an anti-crisis code within its structure and, thus avoids the inflation and deflation of bubbles.

The resilience of the Islamic financial institutions in the face of the global financial crisis of 2008, which was a crisis produced by the speculative operations of the financiers, sharply increased the interest in Islamic financial system.

Whereas many conventional banks and insurance companies encountered liquidity problems that led many of them to bankruptcy, the Islamic financial institutions minimised the negative impact of the crisis and even demonstrated growth. According to the ISFL (*International Financial Services*, London) data from 2008, in the midst of the global financial crisis, the assets of the Islamic financial industry increased by 25 percent, totalling USD 951 billionby the end of 2008compared to USD 758 billion by the end of 2007.

Economists and financiers worldwide analysed the reasons behind this resilience. The tools and products of the Islamic financial institutions began to attract the attention of both theoreticians and practitioners of the financial and business sectors.There was a range of reasons. First, since the beginning of the crisis, a number of Western countries faced liquidity crises, which forced the Western banks to seek financial sources in the Gulf countries. Another reason for the wide spread accessibility of the data on the Islamic financial system was due to the advancement of information technologies, which theoretically excluded the speculative tools and methods that led to the crisis.Finally, the greater demand for Islamic financial products and services from Muslims played a significantrole.While the main criteria in the preferences of non-Muslims for Islamic financial products were the economic benefits that stem from their use, the Muslims are primarily guided by the principle of compliance with the Islamic norms and principles, both in everyday life and when conducting business.

Islamic banking is one of the most rapidly growing financial sectors, which after the recent global crisis, is attracting the attention of investors who are looking for alternative means of investments. Furthermore, moral principles that are at the core of Islamic finance, according to many opinions, make it a more viable alternative than the traditional profit-oriented banking options.

To understand the reasons behind the resilience of the Islamic financial institutions to the global financial and economic crises, one has to understand the essence of Islamic finance, that is, its special features and distinctions (advantages) compared to the conventional financial system.Notably, the assessment of the Islamic financial and economic system, from the perspective of a classic political economy without considering the specific features of Islamic economics, leads to a misunderstanding of its basic principles and mechanisms.

Islamic finance is a system of legal relations that enable the system to finance the production of goods and services according to Islamic requirements. *The financial system of the Islamic world is based on five principles: (a) it bans loan interest/usury, (2)it rejects speculation, (3)it prohibits the financing of prohibited forms of business (including the production of alcohol, tobacco, and pork), (4) it requires partners to share profits and losses, and (5) it promotes asset backing of securities*[1].

The Islamic economy can be described as an economic system that is based on the norms and principles of Islamic law. This, however, does not mean that the operations of Islamic financial institutions are regulated solely by the norms of Islamic law.The mandate of the Islamic financial system is universal in nature, and the Islamic financial system is not only designed for Muslims. It is also notable that the Islamic economy is not identical to economic systems of so-called Islamic countries or the members of the Organisation of Islamic Conference (OIC).

There are several key distinctions between Islamic and traditional financial and banking operations. First, Islamic financial institutions refuse to charge interest. Actually, the entire system is built on the “seller-buyer” relationship rather than on the “lender-borrower” system.

The Islamic financial system also prohibits investments, which may cause harm to the people or the environment. The moral aspects of Islamic finance attract traditional banking institutions that want to learn lessons from the crisis.

The substantial link of the financial market to the real sector is a significant point to explore because of the loan interest restrictions. It is the virtualisation of economic relations driven by the independence of finances that is responsible for the most current crisis. Many researchers (not only Muslim ones) claim that orientation to the real sector explains the resilience of the Islamic institutions to the global financial crisis.

1 GhassenBouslama, finance professor at the Reims Management School http://www.ippnou.ru/article.php?idarticle=007317

The Islamic economy is based on the philosophy that money does not have any value; rather, it is only an exchange tool. In this sense, the bank serves a totally different function; that is, it is concerned with the turnover of money. In other words, the financial system, as determined by Islamic criteria, is most strongly linked to the real economic processes.

The most recent financial and economic crises illustrate substantial risks to the currency system based on the perception of money as a commodity without any consumer value. The Islamic model stems from the perception that money is a medium of exchange, which was a traditional belief held over the entire history of humankind except the last 50 years. Thus, in of itself, money represents value (gold, silver), but it not seen as a commodity, that is, it cannot grow on its own.

As a result, the Islamic economic system is developing in two directions. First, there is a gradual return to hard currency, an idea that is being discussed in the West.Therefore, it is important to remember the idea of Boris Gryzlov, the Speaker of the State Duma of the Russian Federation, with respect to the introduction of the palladium ruble, as well as the proposal of Robert Zoellick, the head of World Bank, with respect to tying base currencies to gold.

Second, there is the gradual substitution of a loan-based economy by a cooperation-based economy, in which the revenue of the financial partner involves assuming project risks. Along with the ban on unjustified risks, this cooperation-based economy enables a rather sustainable system of social responsibility focused on the development of the real sector of the economy.

Synthesising the interpretation of various scholars, one can consider the Islamic economy as a science that seeks the best use of resources to produce the maximum number of permitted goods to meet public and individual needs, according to the Islamic codes.

Furthermore, this *happy medium* between absolute private property under capitalism is almost fully negated under classic socialism.

Special features of the Islamic economic theory, which we will review herein,aid us in addressing the issues faced by the global economy.It is clear that not everyone, even within the Muslim countries, is rushing to implement this tool. The UK's experience, where the government has set the goal to transform London into the European centre of Islamic finance, is noteworthy. In 2000, the Bank of England, jointly with the Treasury, established a task force to review the prospects for and the challenges of the development of this sector. Consequently, a number of essential changes were made in the national tax and regulatory system in 2003. Currently, five Islamic banks and 17 Islamic branches of conventional commercial banks, including City Group, Deutsche Bank, HSBC, UBS, etc., as well as Salaam Halal, an Islamic insurance company, are operating in the U.K. where Muslims constitute only 3 percent of the country's population.

There are two options for establishing an Islamic economy. One is to islamise all economic terms and products adopted in the non-Islamic world. The other is to completely separate from all Islamic terms and products.

The first option borders on hypocrisy and is detrimental to Islamic banking. It is based on a product that has merely been islamised following the Sharia requirements. That is, international banking must be ingenious in devising new products. By adopting the first option, Islamic bankers only have to developways to islamise the new products of other banks to lure clientele. They (i.e. Islamic bankers) would want Muslim banks to be equally as successful as non-Islamic banks with respect to complying with Islamic norms.

We are only beginning to explore the second option. How can one detach from existing financial tools and be confident that the product has been developed based on the fundamental provisions of Islam? In this case, one adopts a certain business practice and begins to model it. This approach is now being seriously discussed in the circles of Islamic scholars and bankers.

Without a proper understanding of the Islamic finance system, it is impossible to provide a precise description of it. One of the key problems with the system is the prohibition by Islamic law of loan interest. All existing denominations (mazhabs/schools) within Islam are unanimous in the opinion that the economy must be built on the principle of excluding usurious interest. In the Muslim tradition, this type of interest is referred to as *riba*.

A detailed review of the ban on loan interest finds that this is not specific to Islamic law only, however, because other monotheistic religions, such as Judaism and Christianity, also promote this belief. It is important to understand the causes of dissemination of Islamic finance beyond the Muslim world. Islam is not the first or the only religion that condemns the charging and paying of interest. Similar attitudes toward usury can be found not only in monotheistic societies but also among polytheistic people of ancient times.

While some may believe that usury was a Greek invention, the charging of loan interest was actually the achievement of the Sumerian civilisation and was, in fact, facilitated by the Sumer clergy – the priests. It is well-known that temple usury had reached its greatest heights when loans were issued by the temples. Subsequently, the practice of charging interest was borrowed by Rome and Greece from the Phoenicians, and it was subsequently adopted by other European people. For instance, in Rome, the finances, trade, and tax collections were the prerogative of the horsemen. Sometimes, entire kingdoms in the eastern provinces of the empire would become dependent on the horsemen-usurers. While in Italy,loan interest was capped by law, no one limited the loan interest rate in the provinces; thus,it could reach 50 percent. If the borrower was unable to repay, his toll would be slavery.

Usury significantly contributed to the polarisation of the society within countries. The only effective means of control of the negative implications of usury were royal amnesties, that is, the forgiving of the debts of the debtors. Such amnesties were popular in Sumer, Babel and Assyria.

Another means of partially overcoming the implications of the negative impact of usury on the society were the strict deadlines ascribed to the repayment of the debt.The debtor, who became dependent on the lender and was forced to repay his debt with labour, would be auto-

matically relieved of his debt upon expiry of a specified amount of time. These measures, however, were not focused on the abolition of usury but were designed to limit the arbitrariness of the usurers.

A negative attitude toward usury in religious literature was first clearly formulated in the Torah. The Old Testament contains the thesis that the righteous man *"does not take advance or accrued interest…"* (Ezekiel, 18:8). The Torah asks that one be mindful of the borrower: *"When you make your neighbour a loan of any kind, you shall not go into the house to take the pledge. You shall wait outside, while the person to whom you are making the loan brings the pledge out to you. If the person is poor, you shall not sleep in the garment given you as the pledge. You shall give the pledge back by sunset, so that your neighbour may sleep in the cloak and bless you"* (Deuteronomy, 24:10-13).

Meanwhile, other provisions of the Torah indicate that lending money for interest is prohibited only when lending to fellow believers: *"If you lend money to my people, to the poor among you, you shall not deal with them as a creditor; you shall not exact interest from them"* (Exodus, 22:25). However, *"From a foreigner you may exact it, but you must remit your claim on whatever any member of your community owes you"* (Deuteronomy, 15:3).

Warning the Jews about becoming debt-dependenton other people, the Torah states,*"…you will lend to many nations, but you will not borrow; you will rule over many nations, but they will not rule over you"* (Deuteronomy, 15:6).

In order to restrict dividing society into the rich and the poor was introduced the following provision was introduced in the fifth Mosaic book of Deuteronomy: *"Every seventh year you shall grant a remission of debts. And this is the manner of the remission: every creditor shall remit the claim that is held against a neighbour, not exacting it from a neighbour who is a member of the community, because the LORD's remission has been proclaimed"* (Deuteronomy, 15:1-2). In other words, the Torah speaks of the need to forgive debts in the seventh year.At the same time, the Holy Book of the Jews warns against those who avoid lending to the needy because of worry that the debt will be annulled in the seventh year.*"Be careful that you do not entertain a mean thought, thinking, 'The seventh year, the year of remission, is near', and therefore view your needy neighbour with hostility and give nothing; your neighbour might cry to the LORD against you, and you would incur guilt"* (Deuteronomy, 15:9).

The rule of forgiving debts in the seventh year, however, did not apply to the Gentiles, according to the following verse of the Torah,*"From a foreigner you may exact it, but you must remit your claim on whatever any member of your community owes you"* (Deuteronomy, 15:3).

In the modern world, charity funds, which are referred to as gemachs (Hebrew – gemilus chesed – good deed), that make interest-free loans to fellow believers in need have become popular in countries with large Jewish communities. Interest-free loans among the equal (affiliation to one social group) were popular in ancient times, for example, loans among the Greek aris-

tocracy. Such loans were less popular when based solely on belonging to the same ethnic or religious group.

Withregards to the prohibition of usury, Christianity initially does not make a distinction between community members and followers of other religions. Usury is condemned, underscoring that interest cannot be charged to foreigners. *“But love your enemies, do good, and lend, expecting nothing in return”* (Luke, 6: 35), thus reaffirming the call for a tolerant approach to the enemies listed in the Torah and virtually forgotten by then. *“When you come upon your enemy’s ox or donkey going astray, you shall bring it back. When you see the donkey of one who hates you lying under its burden and you would hold back from setting it free, you must help to set it free”* (Old Testament, Exodus, 23: 4-5). Meanwhile, Christ did not reject interest-free loans, telling his followers to *“Give to everyone who begs from you, and do not refuse anyone who wants to borrow from you”* (Matthew, 5: 42).

In the early Middle Ages, the Christian clerics were equally as harsh as their Muslim counterparts in condemning usury in all of its forms. As far back as the 11th century, usury was equated to robbery by the Christian scholars. Selling goods on a loan, if the price of the good was higher than the selling price for cash, also was banned as usury.

In 1139, the Second Lateran Council prohibited all forms of usury. The ban on usury, thus, satisfied Christendom until trade began to develop intensivelynear the end of the 11thand early part of the 12th centuries. Along with the advancement of trade, the need emerged to finance miscellaneous business endeavours. Thus, the church itself, possessing substantial finances, often acted as a lender through its institutions.

In the second half of the 13th century, the sale of goods on loan with a selling price higher than the price of the good if bought by cash was permitted.

In 1516, the Church approved the practice of the Franciscans to open pawn shops and make loans to the poor at relatively low interest rates that were primarily used to cover their costs.

Meanwhile, until the 19th century, the Catholic Church did not dare permitthe charging of interest rates. Martin Luther and Jean Calvin, popular reformers, suggested that attitudes toward interest rates be reviewed. For the Protestants, the issue was not about the banning of usury; rather, it was about what interest rates were considered acceptable and what would be considered excessive, thus attaining the level of usury. Considering that the notion of what is considered an excessive interest rate has changed over the centuries, one can consider de-jure legalisation with respect to what constitutes usury.

Islam stands against usury in all of its forms.

Riba (Arabic for increment) is adamantly condemned by the Qur’an. *“Those who devour usury will not stand except as stand one whom the Evil one by his touch Hath driven to madness. That is because they say: ‘Trade is like usury,’ but Allah hath permitted trade and forbidden usury”* (2:275). Despite the distinctions between trade operations and usury, the Holy Book does not

provide the definition of *riba* itself, containing merely indirect references to one of the most popular forms of usury – the doubling of the amount of debt in return for deferring its repayment *“O ye who believe! Devournotusury, doubledandmultiplied …“* (3:130).

As an example, the Qur’an references the business practices of the Jews who conduct financial transactions based on *riba*, inter alia, in the Arabian Peninsula *“…we forbade them (Jews) good things which were (before) made lawful unto them, and because of their much hindering from Allah's way… That they (Jews) took usury, though they were forbidden; and that they devoured men's substance wrongfully; - we have prepared for those among them who reject faith a grievous punishment”* (4:160-161).

Muslim legal scholars describe two types of riba: (1) *riba an-nasia* (debt-based *riba*) and (2) *riba al-fadl* (excess *riba*).

In its broad sense, *riba an-nasia* exists in the loan agreement and implies any increment to the principal received by the lender as one of the terms of lending for a certain period. Furthermore, *ribaan-nasia* may include increments to the principal that are paid in exchange for a payment deferral.Bank deposits, receiving interest and the use of bank loans with subsequent payments of interest are defined as *riba an-nasia.*

Riba al-fadl (excess*riba*) was known to the Arabs in the pre-Islamic period, but as Islam was opposed to *riba an-nasia*, *riba al-fadl* was not named *riba.*

Riba al-fadl occurs in cases of in-kind exchange of one batch of the same product for another in an unequal ratio and at different times. According to the Hadith, these goods include: gold, silver, wheat, barley, dates, and salt. Subsequently, according to most scholars, this concept involves any differences in the number and/or quality when exchanging homogenous goods.

One Hadith dedicated to *riba al-fald* reads that exchanging gold for gold is usury unless gold does not exchanges hands in equal amounts, exchanging wheat for wheat unless wheat does not exchange hands in equal amounts, exchanging dates for dates unless dates do not exchange hands in equal amounts, and exchanging barley for barley unless barley does not exchange hands in equal amounts. *“Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt; like for like, hand to hand, in equal amounts; and any increase is Riba”* (Canonical Hadith collection «*Sahih al-Bukhari*»).

At first, banning the unequal exchange of the same commodity except in those cases where the exchange is torn over time may seem strange from the perspective of economics of both the Middle Ages and modernity. Another Hadith, however, contains an answer to this question. *“Bilal visited the Messenger of Allah (peace be upon him) with some high quality dates, and the Prophet (pbuh) inquired about their source. Bilal explained that he traded two volumes of lower quality dates for one volume of higher quality. The Messenger of Allah (pbuh) said: ‘this is precisely the forbidden* Riba*! Do not do this. Instead, sell the first type of dates, and use the proceeds to buy the other’”* (Canonical hadith collection “*Sahih al-Bukhari”*).

This Hadith addresses two issues of extreme importance from the economic perspective: (1)banning usury and (2) banning barter transactions. As we are aware, in many modern countries, bartering is prohibited as the barter transactions hinder the turnover of "live" money, thus hindering the efficiency of the country's economy.

However, the Qur'an's prescriptions related to banning *riba* and the respective Hadith of the Prophet (pbuh) did not resolve all issues related to usury.

In fact, discussions over this issue did not abate during the entire 20th century as the Muslim world faced the issue of what to do with the banks and financial institutions given the Islamic ban on usury. The following question arose: do Muslims have the right to make contracts with these institutions and become involved in the activities of these institutions in any way?

The first well-known fatwa, which restricted the definition of *riba*, was issued by Muhammad Abduh, Supreme Mufti of Egypt (1899-1905). He stated that the operations of the savings funds, which emerged in Egypt on the threshold of the 19th and 20thcenturies, established by government and operating based on charging interest corresponded to the mechanism of *mudaraba*.[2] At the same time, Muhammad Abduh's student, Muhammad Rashid Rida, acknowledged that Abduh was concerned with significantly increasing therole of the banks in Egypt's economic life.

Subsequently, throughout the 20th century, Egyptian clerics, including senior sheikhs of Al-Azhar (Mahmoud Shaltut), spoke several times on the issue of usury and frequently declared some forms of interest-based operations as lawful.

Upheaval was caused by the well-known fatwa[3] of the Academy of Islamic Studies under the chairmanship of the Supreme Sheikh Al-Azhar (since 1996) and Muhammad Sayyid Tantawi on December 22 when depositing funds and receiving interest was declared lawful from the perspective of the Shariah by a vote of 20 for and 1 against.

This fatwa by Al-Azhar was sharply criticised by clerics and legal scholars in various corners of the Muslim world. Similarly, the likening of a bank deposit agreement with a mudaraba was also criticised. The main distinction of a mudaraba from a bank deposit agreement is the sharing of risk between investor and capital manager in a mudaraba, whereas with a bank deposit contract, the depositor does not risk capital, expecting the profits in advance.

Tantawi's fatwa was a part of the policy by Egyptian authorities to neutralise the influence of Islamic financial institutions.

Muslim legal scholars in the modern world issued a unanimous opinion to ban any loan interest. In summary, the following provisions formulated in the fatwas of the Council of Islamic Academy of Legal Studies (fiqh) can be underscored:

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2 *Mudaraba* - trust-based investment or joint investment of capital.

3 Fatwa is an Islamic religious ruling, a scholarly opinion on a matter of Islamic law.

1. Any increase in the amount of a loan or the introduction of loan interest in exchange for an extension of the repayment period where the borrower was unable to pay the lender in time and the agreement to increase the amount to be repaid or the introduction of loan interest at the time of the loan agreement can be considered to be forms of usury banned by Sharia.

2. Bank deposits are divided into the following two types, depending on the nature of the banking transactions:
   - Deposits on which interest accrues at the bank that charges interest. In essence, they constitute usury loans (*Riba*) banned by Sharia in all forms, including current accounts, time-bound deposits, deposits paid by advance notice, or savings accounts;
   - Deposits with the banks that comply with the provisions of Sharia related to the investing of funds to obtain a part of the profit. These deposits are funds earmarked for trust-based investments (*mudaraba*). Provisions of Islamic law (fiqh) related to the operations for the joint investment of capital (*mudaraba*) are applied.
3. Fees for the issuing and servicing of loans should correspond to the real expenditures for these services. Any excess over real expenses is prohibited as it satisfies the Sharia-banned definition of usury (*riba*).
4. Paper money is the legitimate medium of payment and has full-fledged value. Sharia norms related to gold and silver, riba, advance financing (*salam*) and other transactions are applicable.
5. Even if the borrower withholds timely payment, demanding that he pay a penalty is prohibited, as it would be equivalent to the usury banned by Sharia (*riba*).
6. Sharia prohibits the issuance, sales, and purchase of bonds as the bonds represent a loan with usury interest (*riba*) regardless of which organisation, private or public, issues the bonds. Bonds with zero coupons are also prohibited as they represent the form of loan interest. These bonds are sold at a price lower than nominal value while the owner uses the price difference as a discount upon purchase. In addition, bonds with prizes are prohibited as the bonds are a form of loanwhere all or some of the owners derive benefit as income or incrementsagainst a total value of all bonds issued. Furthermore, there are grounds to view this scheme as similar to gambling.
7. The issuance of credit cards without backing and the use of credit cards are permitted by Sharia if the servicing does not involve accrual of interest on the amount lent. That is,
   - the issuer can charge a fixed fee to the client for issuance and renewal of the card, which must be viewed as a payment for the service provided to the client; and
   - the issuer can charge a commission from the sellers for the goods and services purchased by the clients, providing the price is equal to the price in cash.

Meanwhile, despite unanimity regarding which transactions are subject to the Quran's ban on r*iba*, there are still disagreements among Muslim legal scholars regarding the compliance with Sharia of some contracts used by the Islamic financial institutions.

The *murabaha*[4]has caused many disputes. Formally, most Muslim scholars recognise this contract as not contradicting the Sharia.However, clear preference for the*murabaha* by the Islamic financial institutions at the expense of other contracts is forcingtheoreticians and practitioners of Islamic finance to limit application of this contract.

Thus, the need in the Muslim world for the creation and development of banks that comply with Islamic requirements led to the establishment of Islamic banks. Given the ban on loan interest in Islam, it was assumed that Islamic banks would to operate solely on an interest-free basis.

Another key provision in the system of Islamic finance is the impermissibility of unjustified or excessive risk in business. This provision is named *gharar* in Arabic, a word that translates to "risk" or "uncertainty".

Clearly, risk and uncertainty accompany any form of business, but there is a difference between imminent business risk and a business deal wherein at least one party undertakes unjustified risk and may incur loss.

It is essential to understand that Islam does not condemn risk. Quite the opposite, risk is encouraged if none of the contracting parties can safeguard itself from the possible losses of the other party or parties.It is acknowledged that risk is linked to any transaction, and therefore, participants must assess the extent of risk based on existing information and realise the implications of their actions with respect to any possible scenario. However, Sharia prohibits senseless risk, that is, risk above "normal".

Practically any *gharar* means automatic asymmetry, and one party in the deal has less, or inadequate, information about the subject of contract, thus bears unjustifiably high risk. The reason for banning *gharar* in the Islamic economy is to prevent unjust domination of one party over another, which is expressed as externalities[5] or benefits not reflected in the contract. This, in principle, conforms to the views of the followers of the neoclassical school, which assumes that uncertainty hinders the efficient utilisation of resources.

As previously mentioned, the parties themselves should reduce the degree of *gharar*. However,realising that people do not always behave ethically, the government assumes an important role in the Muslim economic doctrine: the government regulates the economic behaviour of economic agents and intervenes in cases where there is a violation of rights.

4 *Murabaha*– a type of loan without interest rate.The bank buys the good and sells it to the client for payment in instalments.

5 *Ex*ternalities – costs or benefits not stipulated initially and received by the parties of the deal.

The definition of *gharar* is bordered by the definition of *maysir* (gambling) and refers to any activity that is focused on generating profits without the productive investment of resources,in other words, non-productive income. In the modern world, options, futures, insurance, hedging contracts, financial market speculations or casino games serve as examples of *gharar* or *maysir*.

As previously mentioned, the Islamic financial sector has, more or less, successfully overcome the global crisis as a result of the strict ban on investments in risky instruments, such as bad assets and derivatives, and due to the concentration on transactions with real assets.

One of the key questions that Muslims have attempted to answer is, "Can these new institutions operate as full-fledged banks, providing the range of banking services essential for clients, or will they have to be content acting as a charity institution operating without profits?"

As an intermediary in the payments between economic actors, an Islamic bank is not significantly different from a conventional bank in that, in both cases, a commission is charged for the provision of services and, as a rule,a percentage of the amount is transferred with the bank actingas the financial intermediary. Acting as a financial intermediary for legal entities and individuals, the bank intends not only to cover all of its costs but also to generate profits.

A number of modern mechanisms, known in the business circles of the Muslim world for many centuries, were designed to address this problem. The *mudaraba* is one of the most well-known, and along with the mechanism of *musharaka*, constitutes the platform for investment financing of Islamic banks.

However, it is well-known that any investment activity is impossible without raising capital, and this contributes to the generation of the bank's liabilities as liabilities of an Islamic bank are generated by a client's funds in current savings and investment accounts.

2. Current and Savings Accounts

The distinction between a current account and a savings account at an Islamic bank is the same as at a conventional bank. Upon opening a current account, the client, without demanding any remuneration from the bank, is able to freely dispose of the funds in the account. Usually, the contractual terms specify a commission charged by the bank for transactions.

When opening a savings account, the client expects remuneration.According to the requirements of Muslim law, however, this remuneration should not be a fixed interest from the amount of deposit but should represent a fraction of profits earned by the bank using the client's capital.Similar to conventional banks, the client cannot freely dispose of the funds in the account and should maintain a certain amount as specified by the contract.

According to current practice, Islamic banks can choose one of following mechanisms when establishing savings accounts for clients:

1. Accept savings deposits based on *Wadia*[6]. Clients authorise the bank to use the funds while the bank guarantees the deposit to be reimbursed. As for the profits, payment to the client is at the discretion of the bank.
2. Regard savings deposits as *Quard Hasan* (interest-free loans) provided by the client to the bank. As remuneration to the client, the bank can pay non-fixed profits and/or grant discounts to the client for the utilisation of its services.
3. Open savings deposits with the right to invest and share profits within a given timeframe (*Mudaraba*).
4. Transform savings accounts to investment accounts.

Similar to conventional banks, Islamic banks also provide services to their clients such as the issuance of checks, transactions with promissory notes (bank drafts, bills of exchange), traveller's checks, etc.

Additionally, clients can obtain a debit card. As for credit cards, if it serves for non-cash payments where the issuing bank does not charge any additional payments to the holder of the card other than commission for issuance and servicing, the use of this credit card is considered permissible.

There are no fines for overdue payments by the client or owner of the credit card. If the client does not pay his dues on time, the bank is entitled to withdraw the overdue amount from client's[7] special account.

3. Investment accounts

Contrary to conventional banks, an Islamic bank transfers the credit base of financial business into investment business. The deposits placed in a special investment account by the clients of the Islamic bank invested by the bank in miscellaneous financial projects. The profits received by the owner of the account depend exclusively on the performance of the bank's investments.

Investment accounts are also referred to as joint accounts or profit/loss sharing accounts and are explained by the mechanism of *mudaraba*, which is based on investment accounts of Islamic banks.

According to classic *mudaraba* (known since pre-Islamic times and, thus, called pure *mudaraba*), one party (*rabb-ul-maal* or owner of capital) provides funds to the other party (*mudarib* or manager) for management. The profits are divided among the parties according to pre-agreed proportions as determined by the practices of the Islamic banks.

Use of pure *mudaraba* deprives the capital owner of the right to interfere in project management. After the contract between the capital owner and the *mudarib* takes effect, the capital

6 An amount deposited whereby the depositor is guaranteed his funds in full upon demand.
7 The client's special account is opened by the bank under the client's name. The client deposits a certain backup amount for this period that he cannot draw on. In case the client defers on monthly payments, the bank can withdraw the amount needed to cover a negative balance in the main account.

owner merely expects his share of the profits. Clearly, this mechanism involves high risk and does not generate much enthusiasm by Islamic banks as they prefer to use a *two-layer mudaraba*. Under this contract, the bank has dual roles. It serves as the *mudarib*, raising clients' funds and as the *rabb ul-maal*, investing these funds into miscellaneous transactions as permitted by Sharia. As in the case of *mudaraba*, the clients are guaranteed not a fixed income but only partial profits should this occur as a result of investments.

Depending on the object of the investment, the *mudaraba* can be limited or unlimited, depending on whether the client's funds are invested in assets specified by the client or assets identified by the bank.

In Islamic financial institutions, *mudaraba* is divided into special and general. If the client prefers that his/her funds be invested and managed separately from the funds of other clients, then, the relations with the bank are based on special *mudaraba*. Otherwise, rules of general *Mudaraba* are applied.

Investment financing is practiced by Islamic banks in the following ways:

- joint commercial and investment activities;
- bank shares in a company's capital through the purchasing of shares;
- investments in miscellaneous securities in compliance with the requirements of Islamic law.
- joint lease operations between the bank and the client.

Islamic methods or financing mechanisms are divided into two groups:

1. Methods based on the mechanism of distribution of profits and losses or investment methods of financing (mudaraba, musharaka);
2. Methods based on debt financing (murabaha, salam), and istisna and ijara

All aforementioned methods are used in active transactions of Islamic banks in one way or another.

1. Methods based on the mechanism of sharing profits/losses or investment methods of financing (*mudaraba, musharaka*)

Notably, according to the principles at the core of the *mudoraba* financing method, all risks related to the financed project, including its implementation and returns, are borne by the financier (*rabb ul-maal*), that is, the bank. For a number of reasons, such as absent legal frameworks in several countries that enable them to implement transactions based on the system of sharing profits and losses, this financing method (*mudoraba*) is not widely encouraged in Islamic banks. Because of the high moral risks, the banks strive to minimise the use of *mudaraba*.

Contrary to a *mudaraba*, where only the capital owner (*rabb ul-maal*) bears the losses, according to the *musharaka*, every party bears the risk of loss of contributed capital if the joint venture fails.

According to a *musharaka* partnership, which is usually a long-term agreement, two or more persons combine their contributions and finance a joint business/investment project.The mechanism for sharing profits between the participants and the share of each is determined by the parties in a special contract. Likewise, the losses are divided among the parties according to their proportionate share of invested capital.

A *musharaka* is often a more convenient mechanism than a *mudaraba* for Islamic banks because the capital owner has the right to intervene in project management and can thereby influence or overcome negative implications of information asymmetry and accompanying moral risks.

The contribution of the co-investor to the authorised funds of the new company must have the specified amount available to the company without deferral. Funds expected to be received in the future, for example, profits of operations from another company or debt cannot be accepted as contributions to capital as it creates *gharar*. However, property can be contributed, which will be considered at market cost or another monetary equivalent as agreed upon by the founders.

In its miscellaneous modifications, *musharaka* became popular in many sectors of the economy such as project financing, mortgage financing, export and import operation financing, etc.

2. Methods based on debt financing - *murabaha*, *salam*, *istisna*, and *ijara*:

A *murabaha* is a type of sale agreement between one party (the seller) and another party (the buyer) at an agreed upon price that includes the seller’s markup on the price of the good. In a broad sense, a *murabaha* is financing through the purchase/sale of an asset.

The *murabaha* takes effect after the bank purchases the good from the third party because according to Islamic law, the key condition of the *murabaha* agreement and the subsequent transfer of ownership rights for the object of the contract is the actual possession of the good by the seller (bank).

After the *murabaha* takes effect, the bank sells the good to the client at the price, which includes margin, usually with a deferral of payment. Ownership rights for the goods bought by the bank depend on the agreement between the bank and the client and can be transferred to the buyer-client at the very beginning of the deferral of payment.

A *murabaha*, as a financing scheme, is short-term in nature. Compared to the mechanisms based on sharing profits and losses, a *murabaha* features low risk. The most significant risk is

the refusal by the client/buyer to buy the good. According to general rule, the buyer can refuse to buy and the bank cannot penalise him.

Furthermore, before a *murabaha* takes effect, that is, before the bank purchases the good, the bank bears the risk of its accidental loss and the risks related to the possession of the good, including the risk of a changing market price for the good.

Salam or bay as-salam (advanced financing) is the sale of goods with deferral of delivery against cash payment. The function of the Islamic bank as a trade institution is best expressed in *salam*.

Under *salam*, one party (the bank) provides the other party (the contractor) with a certain amount that is equivalent to the value of the good, whereas the other party commits itself to supply the good by a certain deadline and according to certain specifications agreed to by the parties. Thus, the bank acts as a buyer, and the other party acts as a contractor. According to the contract, under continental law, the contractor manufactures products or provides services using his/her ownresources, the buyer receives the goods and then the buyerpays the contractor.According to *salam*, the bank lends to the contractor, who then bears the debt, which will be cleared after the delivery of the manufactured product to the bank.

The bank, which is essentially a financial intermediary rather than a trading or manufacturing company, cannot sell the good immediately as the good is not yet in the bank's possession. In fact, there is only a debt of the contractor, and the debt cannot be an object of trade, according to Islamic law.

The way out of this situation, as in the case of the *murabaha*, is to enter into another contract, so-called parallel *salam* where the bank acts as the supplier of the good.

Salam permits a piece-by-piece delivery, providing, if it does not contradict the nature of the good. It is not substantial whether the good is produced independently or comes from another source; the key is to comply with specifications, numbers, and deadlines.

To this end, *Salam* must specify the deadline for implementation either by way of a specific date or an event, which must occur imminently. It is not permissible to sell the good purchased by the buyer under *salam* until the good is no longer the property of the seller (the buyer under *salam*). The ultimate principle of *salam* is the actual availability of funds at the bank as specified in the contract at the time of the making.

If, upon expiry of the term of the contract, the contractor cannot transfer the good to the buyer, the buyer has the option to wait for the moment when the executor has the opportunity to sell andupon dissolution of the contract, may demand that the funds provided to the contractor be repaid.

Islamic law bans penalties or other fines for delays in compliance with contractual terms of s*alam*. According to Muslim scholars, fines can be envisaged by all financial agreements except those where the basis is debt, that is, any increase in debt is considered usury (*riba*) as the ad-

vance funds provided in this case constitute debt, and according to Muslim law, it is prohibited to increase the debt in the case of deferred repayment. Debt instruments are not permitted to be used as an advance under the advance financing contract as they constitute a sale of debt instruments in exchange for debt, which is prohibited.

Experts view s*alam* as a highly effective tool of the Islamic economy, which meets contemporary requirements for short-term, medium-term, and long-term financing. For Islamic banks, *Salam* is convenient primarily for financing miscellaneous agricultural projects.

Istisna is a type of s*alam* contract, according to the opinion of most Muslim legal scholars. The key difference between *istisna* and *salam* in the banking practice is that it is not the client but the bank that is the supplier of the good in the *istisna*, while the payment for the good is not in the form of a lump-sum before the receipt of the good by the buyer, but gradually as work is completed by the manufacturer of the good.

Istisna's mechanism is applicable only to manmade products, not natural products.

Having received the order from the buyer (client), the bank sub-contracts with a special company, such as the manufacturer of goods or the service provider, to make the payment. The profit of the financier comes from the margin between the price agreed upon in the first contract (prime contract) and the price paid under second contract (subcontract).

Istisna is used for the financing large-scale industrial projects or the purchasing of major equipment, such as aircraft or ships. This mechanism can also be used for home construction. In the latter case, an individual applies to the bank to finance home construction. Giving its consent, the bank assigns and finances the construction at the land plot purchased using its own (the bank's) funds lent to the third person or the client himself. Upon completion of construction, the regular sale agreement of the built-up home can be made between the bank and the client or a sale agreement under *murabaha* can be drafted or the relations can be based on a *ijara* and *istisna*. Ultimately, the bank makes money on commission.

The main shortcomings of an *Istisna* include high risk and numerous technical difficulties.

An *ijara* is widespread in the operations of Islamic banks. An *ijara* is very similar to what is known in the continental system as a financial rent or lease agreement.

The main distinction between an *ijara* and a traditional lease contract is that the latter is a consensual contract[8] that takes effect at the moment of signing while a *ijara* is considered an official and real contractmade at the time of the transfer of property, the object of the lease. It is also noteworthy that the lessee does not have to pay the full amount of the lease payments under the *ijara* contract if the object of the lease becomes unfit for use. The Islamic bank, acting as a lessor, is liable for insuring the object of the lease and is obligated to pay the insurance

8 Agreement, making of which requires only the consent of the parties.

premiums while the amount of the lease payments remains unchanged for the duration of the *ijara* contract.

Ijara and *iqtina* are also found, in the practices of Islamic banks, to be a form of the *ijara* mechanism, that is, a lease with a subsequent buyout. A lease with a subsequent buyout is often used to purchase expensive equipment, such as factories or machinery, and to finance home construction. The main distinction between a lease with subsequent buyout from a simple or operational lease is that the bank's client bears liability to buy the equipment, building, etc. by the end of lease period (i.e., the amount of payments from the client reaches the selling price agreed upon by the parties).

Another important instrument developed under Islamic finance is the Islamic bond, known as a *sukuk*. Actually, from the perspective of Western economic theory, an Islamic bondis a bond supported by specific highlyliquid assets. Buyers of a s*ukuk* have a certified ownership right to share in company assets using the funds received by selling bonds, and they also maintain the right to claim the profits (risk).

These certificates are bought back by the maturity of the bonds and accompanied by formal procedures of liquidation of the partnership through the buyout of respective shares of assets. The beneficiary or issuer of Islamic bonds can be either amanufacturing companyor a bank with specific income-yielding assets.The issuance of these sovereign bonds is frequent in Bahrain, the UAE, Malaysia, Qatar, and Pakistan.

Most often, issuers of a *sukuk* use the composition of the issue of bonds as the basis for a number of legal contracts regarding the purchase, sales, and leasing of the specific manufacturing of goods or of other assets. Islamic obligations related to *ijara* account for half of all *sukuk*s worldwide. Nevertheless, there are no uniform market standards as yet, and every issue of a *sukuk* has an intricate legal structure that requires investors to undertake thorough and costly risk analysis, thus making their decision-making procedures more difficult.Furthermore, in most cases, Islamic bonds allow for regular fixed profit-sharing payments in a partnership. This has resulted in considerable criticism by Muslim legal scholars who note the similarity of this practice with interest payments. Respectively, there is a risk of overruling the decision of the Sharia council on approval of the issue or issuance of a contradicting ruling by another Sharia council.

The uncertainties related to the issuance of Islamic bonds led to them being the most vulnerable element of the Islamic economy during the global crisis. As a result, sukuk issuance fell away during 2008 to $15.77 billion, after having reached USD 46.65 billion in 2007.

Despite the challenges of development, competition, and inadequate experience, the Islamic financial system demonstrates solid growth prospects. The increased degree of the availability of resources is related to the substantial financial potential of the Islamic world. Furthermore, the increased attention of the international community indicated by the demonstrated resilience of the Islamic financial institutions to the last global crisis is a reliable platform for the

implementation of this economic model. Thus, amid globalisation, Islamic finance will play an increasingly important role in the global economic system. However, for the time being, one can conclude that the Islamic economy has demonstrated a certain resilience to withstand financial crises.

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