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Principles and instruments of Islamic financial institutions

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Abstract

Islamic financial institutions are part of the modern world economy and subject to the same economic laws as any other traditional financial market participants. Statesmen and traditional banks see a promising business opportunity in Islamic banking and finance. The mechanism of Islamic capital market is differs from the well-known. Economic agents are guided not only by legal rules but also by the rules prescribed in the Holy Scripture, the Quran. Islamic finance provides a variety of financial products. The main instruments of financing used by Islamic financial institutions have some distinctive features: estimating the value of any asset on the basis of its real value, every contract is concluded exclusively on one type of financial services, a clear definition of the prices of goods/services, a clear definition of the share of each partner in profit/loss.

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1. Introduction

The geography of the Islamic financial business covers more than 50 countries, including countries of Europe, CIS, USA, Australia, etc, where more than 300 Islamic financial institutions operate nowadays. Their total assets exceed $ 1 trln. with the annual growth rate of 10-15 % (Bekkin, 2009).

Islamic financial institutions are part of the modern world economy and subject to the same economic laws as traditional (non-Islamic) financial market participants. In practice, the role of Islamic finance is increasing every year. Consider some of the reasons causing this phenomenon (Srebnik, 2010).

First, in many countries there has been a rapid growth of the Muslim population. The Muslim community in Europe is becoming every year more and more to be taken into account by politicians as well as economists.

Secondly, there is currently a growing interest in Halal (allowed) financial products is observed among non-Muslims. Investments of European banks in sukuk (Islamic securities) aroused interest among private investors who would like to take into account ethical and/or religious aspects in their investment decisions. Choosing the Sharia-

1

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compliant products, they can be sure they don't invest in unethical from the point of view of the religion industry. This can be important also for Christians and Jews: they can be assured that prohibited interest is excluded.

Thirdly, there is a wave of issuing licenses and permits, which allows you to start providing retail banking (mortgages, insurance and loans) in accordance with the Shariah. European governments changed their policy, they now calls to pay more attention to the needs of Muslim communities in Europe. The authorities have begun to respond to these needs that were not taken into account. The fear of alienating a significant part of European society and the threat of the destruction of stability has played a great role in the process of changing the official position.

Fourth, government officials and traditional banks saw in Islamic banking and finance promising business opportunity, and not a "handout" of ethnic minorities. In addition, a large number of professional investors want to include Islamic financial products in their portfolio for diversification purposes.

2. Restrictions in Islamic economic model

The Islamic economic model is primarily intended to optimize the operation of each party's financial processes. To improve the effectiveness and addressing inequities in economic relations provide the main types of constraints (Semenova, 2009):

1. The ban on usury. Rhiba (the surplus) is any unjustified increase of capital in the loan. Any transaction, which depends only on the term and amount of the deposit and not depends on the success of investments is prohibited because of rhiba. Thus, rhiba covers not only usury, but any interest in the usual traditional sense. The prohibition of rhiba is associated with the Islamic view on social justice, equality and property rights (Paldi, 2014). Islam encourages profits only as a result of activities, leading to the formation of any final product, condemning the use of percent in profit.

2. Division of profit, loss or risk. Due to the prohibition of interest, capital owner is not a lender but investor. Thus, there is risk sharing between the owner of capital and the user of capital, as there is no guarantee of regular income. However, in case of success of the project, the investor participates in the direct distribution of profits.

3. Money as "potential" capital. The money will become capital only if it is invested in some business.

4. Prohibition of speculative behaviour. Operations based on the random event or speculation (in Arabic known as “maysir”) and not on the action of the parties aimed on generating income are considered to be invalid in Shariah. In this regard, in the Islamic financial system it is extremely complicated to use the derivative financial instruments which have significant risk level. The most of derivatives has no supposed delivery of real base asset, leading to the rapid development of speculation in the financial market. Buying shares with a relatively short holding period (exchange game) can be also attributed to speculation.

5. Sanctity of contract. The indefeasibility condition of the contract is the most important condition of the transaction.

6. Prohibition of uncertainty (gharar). When entering into a contractual relationship, the parties must fully disclose their intentions and information to each other, because the transaction that contains gharar will be prohibited. Any transaction where the subject of the transaction, the price or both are not defined and not fixed in advance will be considered suspicious by the Shariah. Islam condemns obtaining unilateral advantages by more informed party of the contract.

7. The ban on investments violating public interest. Investments inherently must comply with the principles of Shariah. Operations associated with certain types of products are prohibited; such products include pork, alcohol, arms, gambling and traditional fixed-income financial products. Islamic institutions can (depending on the views of the Shariah Council) to face challenges when investing in such activities as hospitality and entertainment industry. Also, the institutes have a black list of prohibited investments composed by the Shariah Council.

The mechanism of Islamic capital market is somewhat different from the well-known capital market. Economic agents are guided not only by legal norms laid down in the legislation of the country, but also the rules prescribed in the Holy Scripture, the Quran.

The transaction under Sharia law must meet six basic principles (Lepeshkina, 2013):

1. the interest is prohibited ("rhiba");
2. the risk should be shared;
3. the speculative behaviour is prohibited ("maysir");

4. use of asymmetric information is banned ("gharar");
5. the contracts should be respected;
6. trade transactions allowed by the Islamic norms should be financed only, i.e. financing the Halal industries.

Consider the principle prohibiting the use of asymmetric information in the context of Western economic models and how this principle, which was announced by the Prophet Muhammad 14 centuries ago is applicable today. Gharar (literally, "danger", "error") refers to such a property contract/transaction, which causes deliberate or accidental omissions in the information by one or both of the parties, or party/parties cannot adequately interpret the purpose and expected outcome of the contract.

Islamic view on gharar as information asymmetry is in its ethical interpretation, i.e. Islam condemns obtaining unilateral advantages by more informed party of the contract. Examples of a contract containing gharar are the next: purchase and sale of goods the seller do not possess now; the transaction without specifying the exact price, for example, with the phrase "current market price"; transactions using insider information, etc. (Srebnik, 2010)

It is important to understand that Islamic economy does not formulate any special laws of economic development, but only alternative methods of doing business, and Islamic financial institutions, as part of the modern world economy, are characterised by the same economic laws as traditional (non-Islamic) financial market participants and partly affected by the same problems that arise in the West (Bekkin, 2009).

The solution of the problem of information asymmetry in the financial market was first proposed in the mid-twentieth century (the Securities Exchange Act adopted in the USA in 1934), and by 1990 the laws governing these issues - the insider trading laws - were enacted in 33 countries, currently the insider legislation is implemented in more than 100 countries.

Violation of the gharar principle (information asymmetry) in the economic activity leads to a destabilization of the market mechanism and substantial losses for investors (usually individuals) or issuers. Remember a vivid example of the largest U.S. energy company Enron, whose shares were considered the standard of reliability until the company announced its financial insolvency in 2001.

By publishing false statements (violation of the gharar principle) Enron inflated the market value of the shares, attracted new investments and direct them to the offshore network. The collapse of this company was a disaster for many American families: together with the shares depreciated retirement savings, depriving the pensions of tens of thousands of teachers, police, firefighters.

It is worth noting that by now Islamic finance have proven their generic nature, ceased to cause confusion and fear among local bankers albeit with a delay of ten years in comparison with the West. The basic principles of the Islamic economic model are actively implemented and applied in economic and financial activities in developed and developing countries with market economy (Naseem, 2014).

3. Islamic financial products

There is a wide variety of Islamic financial products available. Many of them have similarities, however, they are used in different purposes (Kammer et al., 2015). For a more general presentation the most common of them discussed below.

Musharaka (from Arabic "partnership") is a joint project of the Islamic financial institution and the entrepreneur. This product requires the signing of the partnership agreement between an Islamic financial institution and a customer, according to which both parties are funding the project together. Losses are divided in proportion to the participation of parties in the financing (Ahmad, 1976).

The project may be funded by more than two parties. The project is being managed by all participants or by one of them. Musharaka contracts may be used for providing additional working capital for the company or for joint investments, for example, in real estate or agriculture. This type of contracts is used often to finance long-term investment projects (Asmadi, 2011). The scheme of Musharaka is presented in Fig. 1.

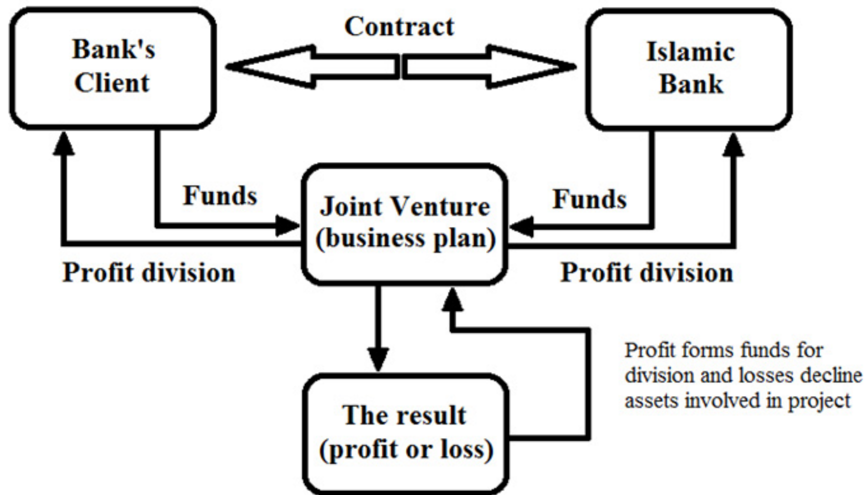

Fig. 1.The scheme of Musharaka transaction (partnership)

The following financial instrument that is actively used by Islamic financial institutions is Mudaraba. Mudaraba is typically used to finance short- and medium-term investment projects (e.g. in retail trade). The Mudaraba contracts are analogous to trust-based financing in the traditional financial system.

The income generated from the invested money is distributed between the financial institution and the entrepreneur in accordance with the agreement, concluded at the moment of signing the contract. At the conclusion of the contract, the parties determine proportion in which the profits will be divided, and not a specific amount of money (usually Islamic financial institution receives 15 to 30% of the profits). The financial institution solely bears losses in case they occur, and the mudarib (the trustee) in that case gets no reward for its efforts. The mudarib (the trustee) has no right to use the funds to finance other projects not covered by the contract without the permission of the client, and cannot attract other sources of funding or to use its own money. The Mudaraba scheme is presented in Fig. 2.

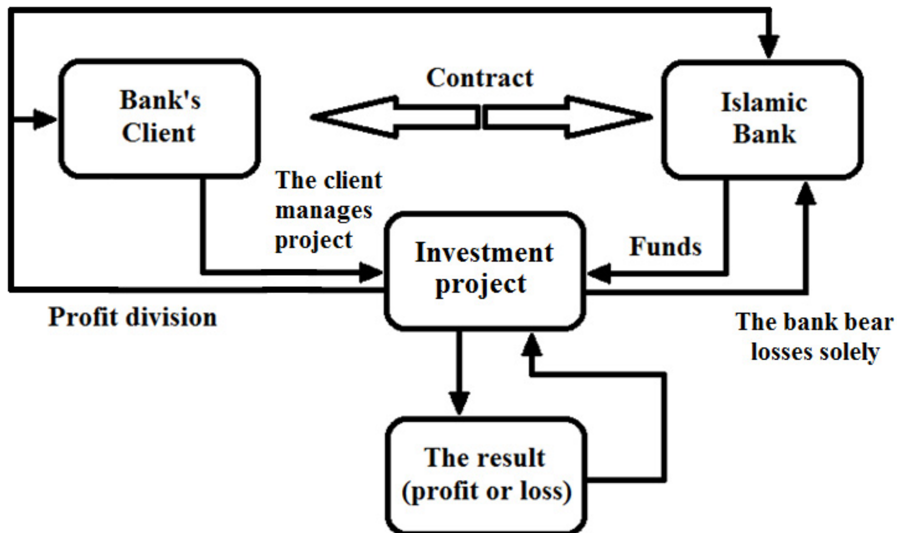

Fig. 2. The Scheme of Mudaraba transaction (trust)

Ijara is a copy of a leasy transaction in the traditional financial system. It involves an agreement by which Islamic financial institution buys equipment, real estate, etc. at the customer's request, and then renting it to the customer. The duration of the lease and rent fee (fixed or time-varying) agreed by the parties. The scheme is presented in Fig. 3.

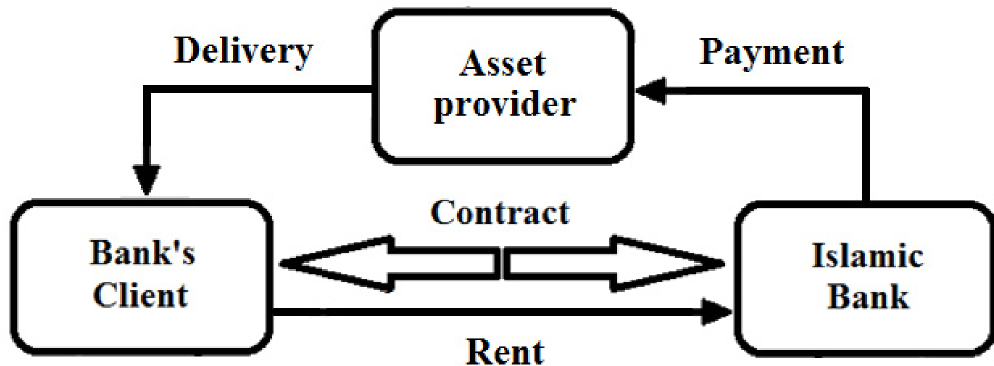

Fig. 3. The scheme of Ijara transaction (leasing)

Under Murabaha contract Islamic financial institution provides trade financing. Murabaha is accompanied by a contract of sale of goods between the bank and its client at an agreed price. The bank buys the goods (raw materials, component parts, etc.) on behalf of the client, and then resells the goods to him, profiting from the sale of the goods, and also extra charge for services rendered. After signing the contract, the bank agrees to provide to the customer the goods, and the date and place of receipt of goods specified in advance. Before the goods are received by customer, the Islamic financial institution bears all risks of spoilage or damage. The Murabaha scheme is presented in Fig. 4

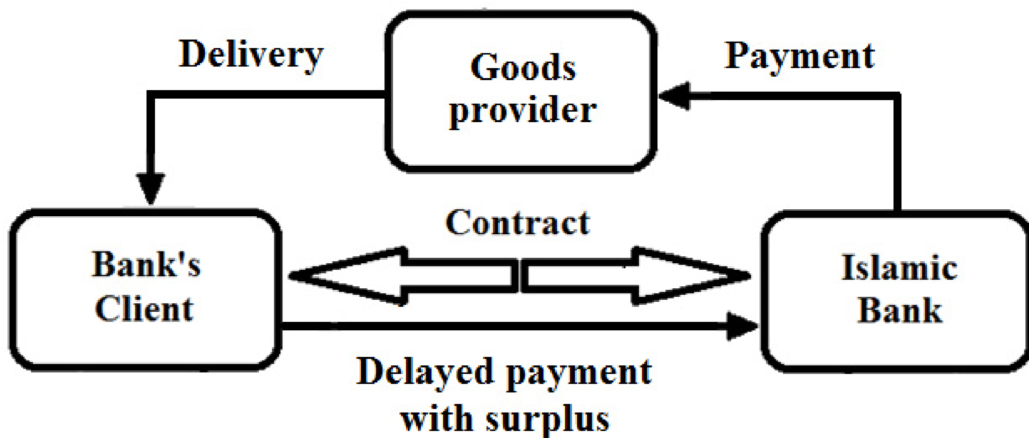

Fig. 4. The scheme of Murabaha transaction (trade financing)

The price of the goods should be determined in advance, and should specify the amount of markup, which is the reward. The client should pay the requested amount (usually gradually - in the form of an annuity payment) within a specified and fixed by the contract time period or as a lump sum. The margin for the bank's services can be specified in monetary terms or as a fraction of the cost of the goods, but must in no way be associated with time expressions ("weekly", "monthly", etc. are not allowed). The client in this type of transaction usually provides collateral to secure Islamic financial institution.

4. Conclusion

Islamic economic and financial principles are inherently socially oriented, entail moral development and a more stable business and, consequently, may have an impact on reducing the level of corruption and dishonesty in the economy. Having considered the basic tools of financing used by Islamic financial institutions, and mechanisms for their implementation, we can mention the following distinctive features of financial contracts. These include:

1. any asset value estimation is based on its real value;
2. the transition of ownership of the goods in the transactions of sale and purchase;
3. each individual contract is concluded exclusively on one type of financial services (for example, in one contract may not be spelled out conditions of sale and rent, as in the case of financial leasing);
4. a clear goods/services price definition (the price formula) included in the contract. Price should not depend on floating interest rates or possible future changes in some other indicators;
5. a clear definition of the share of each partner in profit/loss taking into account the share in the common property or the contribution to the equity capital, or otherwise.

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