



Lomonosov Moscow State University

Moscow, Russian Federation

<http://www.econ.msu.ru>

Preprint series of the economic department

Topical issues related to the formation of the Islamic financial system: at the intersection of philosophy and practice¹

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Article info

Key words: Islamic finance, Islamic banking, riba, gharar, maisir

JEL: F290, F300, G000, E440

Abstract

The so-called Islamic finance is an intensively developing segment of the world finance. It puts a great amount of not so much practical but complex theoretical questions to the financial regulator and professional participants of financial markets. In search of answers financial analytics have to use some philosophical tools of scientific analysis and decision-making. Just a question to illustrate the problem: “At what level (protein, cell, DNA, molecule, atom, proton, etc.) does pork cease to be meat tabooed for Muslims and become a biological material that may be used?”

1. Preface

During the last decade the Islamic finance industry has been on top by its development – demonstrating up to 15% of the yearly growth. This is an important factor arousing strong interest of investor worldwide, regardless of confessions.

It should be noted that despite the fact that the fundamental concepts on which the industry is based are the same (taboo on lending money at interest, i.e. riba; taboo on unjustified risk, i.e. gharar; and taboo on contracts with uncertain terms, i.e. maisir), in different countries it is put into practice in different ways. This is due to the difference in the perception of the practical implementation of these taboos. As a result, in some countries the Islamic finance industry is highly liberal allowing even Islamic futures and options, in others it is extremely strict, but with many exceptions to the rules.

¹ The article is based on the materials collected during the practical training organized for a group of Russian tutors by Russia’s Mufties Council and Al-Baraka Banking Group (Manama, Bahrain). The author expresses his profound gratitude to the bank’s Vice-President Abdulrahman Shekhab for assistance and friendly support during the practical training. During the training the author was able to visit and study the work of a large number of Islamic financial institutions.

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This situation can be understood but should not be put up with. The Islamic finance rules should not vary from country to country only because in each country there is its own perception of how the basic taboos must be practically applied. Therefore, in the author's opinion, one of the first steps to take to solve the problem in future is to formulate the fundamental questions related to the formation of the Islamic finance system and start a motivated discussion.

2. Literature review

There rapidly appear more and more scientific papers on the Islamic finance. By the beginning of 2010 only the Social Science Research Network library alone had more than 170 articles (Ulpan Atazhan, 2011), with most of the articles written by representatives of Western scientific schools, mainly from USA. Many papers are descriptive, which is apparently accounted for by a relatively low level of awareness of the scientific community regarding the fundamental distinctions of the Islamic finance.

Authors of papers acknowledge a wide range of problems, from philosophical to everyday ones. Above of all, it is observed that there are unreasonably too many interpretations of financial rules of Sharia, varying from country to country (Andreas A. Jobst, 2007). In witness of this Charles A. Rarick and Thaung Han (2010) have demonstrated that 85% of financial transactions based on Sharia rules in fact do not correspond to Sharia principles. The authors note that there are a great number of various interpretations of Sharia laws by different philosophic schools. This diversity has an adverse impact; for example, governments of countries with unstable conditions fear that Islamic finance issues may be used to disguise extremist activities. For example, Egypt and Morocco have prohibited promotion of Islamic financial institutions because they claim to be concerned about the Islamic finance allegedly contributing to the spreading of the Islamic fundamentalism. Such countries as India and Nigeria prevent the development of the Islamic banking due to the on-going long-lasting conflicts between Muslims and representatives of other confessions. Furthermore, in some countries, for example, in Malaysia, scientists-members of Sharia boards are limited in decision-making powers (Juan A. Sole, 2007).

Andreas A. Jobst (2007) points out that it is unacceptable to allow mechanical migration of the structure of traditional financial assets to the Islamic finance industry, specifically, regarding options and futures, whose structure does not allow their presence on Islamic financial markets altogether. Unfortunately, in practice financial institutions often tend to introduce innovations and elements that run counter to Sharia principles. For example, Ehsan Zar Rokh (2007) speaks about determining the discount rate to calculate the present value of financial assets though the discount concept is altogether inapplicable to the Islamic finance.

Methodological errors arise also because of monetary control authorities that sometimes lack an integrated perception of the Islamic banking management principles (Juan A. Sole, 2007), which leads, among other things, to incorrect setting of banking standards. Another consequence is underdeveloped or not existing Islamic money markets and typical liquidity problems faced by Islamic banks and financial companies (V. Sundararajan and Luca Errico, 2006). Another problem voiced by Waseem Ahmad Langah (2009) is government guarantees for individual deposits at Islamic banks operating in the West: though not acceptable according to Sharia, the guarantee is obligatory according to the local laws.

3. Theoretical questions related to formation of the Islamic financial system

Question 1. "Can Islamic financial institutions exist, materially and not formally, in the traditional financial system?"

The question is raised because the two financial systems – the traditional and the Islamic – are based on two absolutely different basic documents: the Constitution and Sharia, respectively. The Constitution implies that everything we find around us in the world belongs to people and all laws are made on behalf of the majority. Sharia, on the contrary, states that everything around us in the world belongs to the All-Mighty and is given to people only for temporary use. As far as laws are concerned, they are already written and need to be correctly seen in Koran.

Let me give an example to illustrate how criteria and even concrete figures appear in the Muslim law. Taking about the holiness of the mother status Muslim theologians assert, for instance, that the mother has three fourths of control over her child whereas the father has only one fourth. This assertion is based on an episode from the life of the Prophet Muhammad. Muhammad was asked once whose word was more important for the child – the mother’s or the father’s, and the prophet answered that the mother’s word was more important. Those who heard his answer were astonished and, being sure to hear “the father’s”, asked Muhammad the same question once again. The prophet’s answer was the same: “the mother’s”. Muhammad was asked again and again he said “the mother’s”. Only the fourth time he answered “the father’s”. This illustration drives the reader to the conclusion that control over the child must be shared 75% to 25% and this conclusion may be applied to many relevant situations. The author asks the dear reader not to focus too much on this example, which the author, who is a financial analyst and not a theologian, may have failed to describe to the best. It is just an illustration of how righteous acts may serve by analogy as the basis for drawing up conclusions, including concrete figures, relevant to the present day.

The contradiction defined above is fundamental. It will arise each time an Islamic financial institution operating in the traditional financial system tries to find a correct mechanism to implement in practice this or that financial instrument or service. The Sharia Committee in charge of finding solutions to such kind of problems will look for analogies (possible analogies, similar examples) in Koran and other sources and generate answers according to the logic of Sharia, which, I am pointing it out once again, fully rejects the secular laws. In other words, financial products of an Islamic bank operating in the West will be based on the logic conflicting with the local laws.

In case of serious judicial disputes this contradiction is sure to manifest itself and may lead to a lost dispute. That is why it appears reasonable to publicly state that the Islamic finance is not a way to practise religious needs (and does not exist to satisfy religious needs of Muslims) but is just a form of business. This statement may underlie the regulation of the work of Sharia councils.

Question 2. “What can be a criterion to determine the profit rate in the Islamic finance system?”

This is apparently one of the most complicated theoretical questions. It is not a secret that in their everyday activities many Islamic banks and financial companies are guided by the LIBOR rate or the return on the market index of the equity market or other similar parameters. This undoubtedly makes the Islamic financial model less valuable because it is not fully free of the influence of the Western model saddled with danism.

In the traditional financial system the profit rate is the result of the competitive demand and supply for financial resources. However, to the Islamic system this approach is inapplicable because money resources are not deemed as goods and cannot be an object of purchase and sale. In the Islamic finance system the source of profit of banks and companies is the markup to the price of bought/sold goods. In real life it is determined either through individual negotiations between the bank and the borrower, or is set by the bank on a centralized basis for groups of borrowers. This scheme does not imply any extensive and public competition for such markup.

Perhaps, it is better to set up a special exchange where standardized contracts for particular Islamic banking services will be traded. In any case the question of the correct determination of the profit rate in the Islamic finance system is going to become more and more acute with the growth in the system capitalization. At present the key indicators of the Islamic finance are determined with a look at traditional ones; but it is not wise to ignore that the capitalization of the Islamic finance industry may reach or even surpass the level of the traditional financial system. But if the Islamic finance industry does not have its own theoretical foundation, it may stop developing and even plunge into stagnation.

Question 3. “Can inflation induce the Islamic economy to partially give up the taboo on lending money at interest?”

The question arises because the phenomenon of inflation was not known at the time of the Prophet Muhammad and there is no direct mentioning about it in Koran. Let me make myself more precise: we do not speak just about price variances due to changes in demand and supply for goods, but about price variances caused by changes in the quality of monetary units.

The precise interpretation of the spirit and letter of riba implies that the borrower must repay to the lender as much as he has borrowed, i.e. the nominal value of the credit, without taking into account its purchasing ability. In other words, by strictly adhering to the taboo on danism the Islamic finance system creates conditions when the lender gets in fact less than he has lent.

Naturally, the following assertion appears logical: the borrower must not only repay as much as he has borrowed at the nominal value, the borrower must pay to the extent of the purchasing ability of the borrowed sum, whereby the borrowed amount is increased by the sum of inflation.

4. Practical questions related to formation of the Islamic financial system

Question 4. "How should be organized the Islamic interbank credit market?"

In fact, this is the extension of the previous question, just in terms of the banking system. It is generally known that the interbank credit market is important for uninterrupted functioning of the banking system. However, transactions closed on this market fully contradict Sharia and are inapplicable in the Islamic finance system. But just as traditional banks, Islamic banks need to manage short-term liquidity by covering the daily deficit or by depositing the daily excess of resources. Accordingly, Islamic banks need a venue where they could solve such tasks.

The problem has been attempted to be solved for a long time but so far without any results. One of the most prominent but compromise solutions is the scheme offered by the Libyan Arab Banking Corporation having headquarters in Bahrain. The bank set up a special-purpose company and vested it with a number of assets with a market quotation. The special-purpose company opens accounts to its clients – banks wishing to deposit temporarily available funds. Every evening the special-purpose company zeros these accounts and for all the money sells its clients its own shares, whose value is directly tied to the market quotations of the assets delivered to the special-purpose company. In the morning, just as the trading session opens, the special-purpose company repurchases its shares adjusted for the variance in the price of the quotations of the assets.

There are two points worth noting in this example. First, it is a compromise scheme because it implies only placement and not attraction of funds by clients. Second, there is a rule which says that if the value of the special-purpose company's assets falls, the parent company will cover the loss. This is obviously in conflict with Sharia principles but practically, since the scheme has been accepted by the ABC Sharia Committee, all responsibility for undue operations is borne by the committee experts, and clients serviced by the special-purpose company do not fear being accused of making undue business.

Apparently, the answer to the question about how the Islamic interbank credit market must be organized will be finally found only after the question concerning the profit rate of the Islamic financial institutions is answered.

Question 5. "How should be organized the Islamic stock exchange?"

In other words what must be done to stop speculation by financial assets (even if the issuer is declared 'halal' and its securities are recognized as acceptable for investing)? And what is exactly speculation? This is not a trifle issue because there is no uniform definition of speculation. One of the best explanations of this phenomenon runs as follows: speculation implies operations conducted under the influence of price variance. Accordingly, non-speculative operations are operations conducted after every news event relating to the issuer, resulting in review of the issuer's fundamental characteristics.

As speculation is a type of activity prohibited by Sharia, the Islamic stock exchange must be supplied with a specific mechanism providing for compliance with this requirements. At present all stock exchanges in Islamic countries are created and operate by analogy with Western stock exchanges and, naturally, allow speculation. Therefore, organization of trading on Islamic exchanges needs drastic restructuring.

Question 6. "What is excessive risk?"

Sharia has a taboo on excessive risk even if one operates with allowed assets. But there is no answer to the question to what extent it is allowed to risk. First of all, it is necessary to define the measure of risk. On traditional

financial markets risk is measured by such parameters as return, standard return deviation, beta coefficient, VaR coefficient and others. But all these parameters are based on the admissibility of speculation and discount ideology; therefore, to the Islamic finance industry they are inapplicable. We need new parameters, obviously, linked to a new exchange trading mechanism.

Question 7. “Why is it allowed to have different rates of profit distribution between the bank and the client under investment accounts with different limit amounts?”

Let us take a practical example. In Islamic bank N the client may open two different investment accounts (the client’s revenue on such accounts is determined as a certain percent of the bank’s profit). The difference between the accounts is only in the size of contributions. One account requires a contribution of up to 50 thousand (in this case Bahrain dinars), the other – above 50 thousand dinars. The second account offers the client a better rate of distribution of the bank’s profit between the bank and the client.

As the client opening the first account and the client opening the second account assume absolutely equal risks, because in both cases the subject-matter of the contract is the same (money), logically, the clients should be entitled to equal remuneration in the form of interest, i.e. equal rates of the distribution of the bank’s profit. Unfortunately, in practice, being driven by the desire to attract as much depositors’ money as possible, banks press the Sharia Committee to take illogical decisions.

Question 8. “Why does the bank share its profit with the client long before it receives the actual return on invested funds?”

Let us consider another aspect related to investment accounts. The average period of the return on the majority of projects is known to take several years, and never a month. But exactly a month after the client opens an investment account at the bank the client receives the first payment (let us remember, the payment is made on a bank’s profit sharing basis). But then it is not joint investing by the bank and the client in investment projects, as is implied by the essence of investment accounts, but improvement by the client of the bank’s liquidity, i.e. investment in the bank’s current activity. Something that vaguely resembles the desired market of Islamic interbank credits.

Question 9. “Why does in certain cases the bank voluntarily make additional payments in the client’s favour?”

According to established rules the bank’s profit is shared between the bank and its client at fixed shares, which means that the bank may not decrease the client’s share. But may the bank increase such share? The question is logical because, being aware that the client may prefer to choose their competitors when the bank’s monthly profit is significantly lower the mid-market profit, some banks revise their profit distribution conditions and decrease their share increasing the share of the client. This is usually done without much publicity.

Eventually, the client gets the mid-market profit and has no reasons to break its relations with the bank. The bank, in its turn, gains by retaining the client and not letting its low business performance in the given month become publicly known.

5. Formation of the Islamic financial system in Russia

Russia is not ready for formation of the Islamic finance industry. It is enough to name only two reasons, each of which is self-sufficing. First, launching the development of the industry requires substantial political will of the government top executives, but now the government is busy getting ready to the coming elections of deputies of the State Duma, with the elections of Russia’s President to follow. Given the anti-Muslim attitudes of a part of the population, there are no doubts that the top executive team will not be interested in a politically controversial project even if potentially it can open the door to savings of rich Arab investors. An indirect proof of this is the reaction, or, to be more precise, no reaction of Russia’s money authorities to numerous written requests, including, from Arab international organizations.

Second, Russia is not ready for formation of the Islamic finance because there is no professional demand for services of the Islamic financial institutions (i.e. demand implying good understanding of the purpose of services and their distinctions from traditional ones). Of course, if we ask a Muslim if he would welcome Islamic banks opened in Russia, the answer will be affirmative. But Russian Muslims are a part of the population and like

many others they lack good knowledge not only of particular characteristics of the Islamic finance but of finance in general. Financial illiteracy of Russians is a well-known fact, it would be naïve to think that people lacking the basic financial knowledge would understand the specific nature of the Islamic finance.

There is more to add. As it is known, the Islamic finance is positioned as ethical finance, i.e. aiming not so much at the personal profit but at the social benefit. At the same time, Russia has proved to be a country with a monstrously developed system of corruption and a malfunctioning state apparatus. It is hard to believe that Islamic banks in Russia, especially if founded by rich Arab structures, will be able to operate without corrupt practices forced on them. Banks' Sharia Committees, among whose members there are the most competent representatives of the Arab-Asian world who have for decades built their reputation and are earnestly safeguarding it, will certainly not let the bank management practise bribery. And, technically, this may ruin the business.

6. Conclusions

With respect to the Russian environment, the following recommendations can be formulated. It is advisable to put them into practice in the nearest two-three years until all types of elections and election-related turbulence are over. By that time it is necessary to form a professional demand for the Islamic financial services and a human resources base.

We recommend to:

- change the term “Islamic finance”, which may avert Russians of other confessions, into another term, for example: “Ethical finance”, “Non-traditional finance”, “Participation finance”, “Fair finance”.
- include in the academic programs of higher education institutions the courses “Islamic finance”, “Islamic banking”, “Islamic insurance”, etc.
- set up professional mass media targeted at promoting the financial awareness of the population and specializing in the Islamic economics and finance.
- start up a special rating to assess to what extent a financial company or a bank follow or are ready to follow Sharia requirements in their activity.

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