Islamic finance: current position and its future on the traditional finance market

Anna Romozian

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Lapland University of Applied Sciences

Abstract of Thesis

Lapin AMK
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Author	Anna Romozian	Year	2016
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The objective of this research is to get to know the core principles and concepts of Islamic financial system and to analyze its appearance in non-Muslim countries in order to see the perspectives of Islamic banking on western market. The reason of choosing such topic is explained by rapid growth of Islamic financial institutions in both Muslim and Western countries.

This research includes introduction of the main types of contracts of Sharia-based banking, comparison those to ones used in conventional banks; analyzing the risks that face Islamic financial institutions in western countries, nuances of the regulation and, in the end, propagation of Islamic banking through the world.

The result of the research shows that Islamic financial institutions have the tendency to spread further in Europe and in Russia. That means financial authorities and traditional banks of those countries have to be prepared to such innovation and be ready to face some obstacles.

The area of Islamic banking is not explored in depth. That is why the problem of lack of relevant information was faced during that research. the research method used, the research material, results and conclusions.

Academic articles, books, web sources and presentations were used as sources. All the sources are carefully chosen due to the excess of irrelevant information about the research field.

Key words: banking, Islam, Islamic banking, perspective, financial Institutions

CONTENTS

1. INTRODUCTION

The term "Islamic finance" appeared in the mid-1980s. The Islamic financial system is often described as the financial system where charging of interest is forbidden. However, the principles of Islamic finance are much wider than the rejection of the interest rate. They are based on Sharia - a set of rules and laws relating to management of the economy, social, political and cultural aspects of the Islamic society. Using conventional financial instruments in the Muslim world due to the mismatch with Sharia laws might be almost impossible in some Islamic countries (Shoon 2008, 10–11).

In the last decade, the concept of "Islamic bank" is well established in the lexicon of financiers in many developed countries. This financial institution operating in Muslim countries is gradually beginning to play an increasingly important role in the traditional financial system. In such countries as the UK and the US, where the number of citizens who practice Islam and refuse to use the services of traditional banks, rises repeatedly, ignoring Islamic institutions is no longer possible. In the 2000s, an attempt to open an Islamic bank was made in Russia. Therefore, the study of Islamic financial institutions is quite a hot topic in the world of economic literature and practical interest for the economic agents in most of the European and Asian countries (Jamaldeen 2012, 43–45).

The aim of this research is to describe the basic principles of the functioning of the Islamic financial system, as well as the consequences of the emergence of Islamic financial institutions in the traditional financial markets. In the coming years, some of these institutions may appear in Western Europe and Russia, so the domestic banks, non-financial enterprises, public authorities and the public should be ready for such a development, and aware of the consequences of this trend for the national economy (Jamaldeen 2012, 44 – 45).

In the first part the basic principles of the functioning of the Islamic banking system will be discussed. In particular, it is a description of the structure of Islamic financial system. Financial instruments used by Islamic banks, the balance sheet structure of Islamic financial institutions, as well as analysis of the risks inherent in Islamic banks are to be represented. In addition, I will focus on some aspects of the regulation of Islamic financial institutions. In the second part I will try to highlight the main challenges faced by the Islamic financial institutions at the entrance to the traditional financial markets. The necessary prerequisites will be met before Islamic banks will spread even wider in the traditional financial. The main stages of development of the Islamic financial sector, the role of regulatory authorities in the regulation of Islamic financial institutions and issues of creating the financial infrastructure necessary for the normal functioning of Islamic banks are going to be analysed (Jamaldeen 2012, 44–45).

2. CHARACTERISTICS OF ISLAMIC FINANCIAL SYSTEM

2. 1 Basic principles of operation

In fact, the one most common fact known about the Islamic financial institutions is banning profit by obtaining bank interest and taking excessive risks, including through the use of derivative financial instruments. This rapid development of Islamic banks necessitates a more detailed acquaintance with the peculiarities of their functioning. In particular, it is interesting to study the main products offered by Islamic banks, models of their balance sheets, as well as ways to adapt Islamic financial institutions to the traditional financial system (Schoon 2008, 11–12).

Islamic banks are the most important elements of the Islamic Financial System. The Islamic model of banks performs the same functions as conventional ones. They work for national payment system and act as financial intermediaries. In regard to the financial intermediary function, there is a fundamental difference between Islamic and western banks (School 2008, 11–13).

The ban of interest

Islamic finance prohibits "riba" (surplus), which is understood as any unjustified increment of the capital for a loan or in the exercise of a bargain. In other words, any predetermined rate, depending on the timing and amount of the loan and not dependent on the success of investment is called riba and is prohibited.
Most of the Islamic scholars refer that the concept of riba is not only high and usurious surplus but any lending rate. This prohibition is justified by notions of social justice, equality and property rights. Islam encourages profit, however, condemns the use of percent for profit, since these activities do not lead to creation of a product and cannot increase the welfare of the society. Social justice requires that borrowers and lenders receive compensation or damages on a

parity basis. The process of accumulation and wealth creation in the economy reflects a real contribution to economic agents into economic development (Schoon 2008, 11–12).

Risk sharing

Due to the prohibition of charging interest, those who offer funds in debt, become investors rather than creditors. The owner of financial capital and the entrepreneur share the risks in order to share the benefits (Jamaldeen 2012, 15).

Money as a "potential" capital

Money is regarded as "potential" capital, that is, they become real capital only when invested in production activity (Jamaldeen 2012, 15).

Prohibition of speculative behaviour, maysir

In the Islamic financial system the accumulation of money is not approved and prohibited activity characterized by great uncertainty (Eg, gambling). The name for that in Islam is maysir. Due to the existence of maysir it is very difficult to spread derivative financial instruments, transactions with inherent significant risk is inherent (Jamaldeen 2012, 16–17).

Non-infringement of contracts

Islam considers s the performance of contractual obligations as an important duty of parties of the transaction. These requirements are intended to reduce the risks associated with asymmetry of information and moral hazard. In addition, Islam condemns the gains of more informed party of the contract. In this connection, it prohibits the "gharar" - a deliberate risk that goes beyond the inevitable accident. In general, any speculative transaction falls under the concept of "gharar" (Jamaldeen 2012, 17).

All in all, the key moment in which Islamic banks are different from western financial institutions is that they do not use award in the form of interest payments. However, it was noted that Islam does not condemn the fact of making a profit; the ban is imposed only for a fixed and not dependent on the results of the activities profit. Thus, a fee to the owner of the capital must not take the form of payment of a predetermined amount guaranteed, regardless of the profitability of the enterprise, as in the case of charging interest (Jamaldeen 2012, 17).

According to the norms of Islamic ethics in righteousness only the wealth, this is the result of one's own work and entrepreneurial efforts as well as the inheritance or the gift. In addition, the profit is the reward for the risks associated with any business venture (Jamaldeen 2012, 17).

The bank may receive income, without charging interest, if it is being a member of the project. The bank must fully share both profits and risks. Besides, bank may engage in trade and make a profit from the margins between the cost of acquisition of the product and the cost of its implementation. In this case, only the actual results of operations (and not predetermined in advance interest rate) will affect profit of the bank (Jamaldeen 2012, 17). According to Sharia law financing trade operations related to certain products as tobacco, alcohol, weapons, as well as the proliferation of pornography, development of gambling, etc. is strongly prohibited (Jamaldeen 2012, 18).

Thus, the principles of Islamic banks are not contrary to the principles of operation of the market economy; abandoning the collection of interest does not mean working on charitable basis. It should be kept in mind that there are individual financial institutions which operations are based on the principles of Islamic religious ethics and the whole countries with financial systems which are based on the norms and laws of Sharia (Islamic Capital Market Fact Finding Report 2004).

In addition, each Islamic financial institution has religious advisers constituting the Sharia Supervisory Board. The functions of this body are admissible certification of financial instruments, calculation and payment of the "sunset" (wealth tax. In Muslim countries, the tax is levied on the property of wealthy Muslims. It promotes distribution of wealth in society. These funds are used to support the poor in Muslim society, to finance the projects for improvement their life and community service.), checking bank transactions for compliance with Sharia and development of recommendations on the distribution of income and expenses between the investor and the bank. There are also centralized authorities supervising compliance with Islamic activities of banks (Ayub 2007, 387).

To summarize some facts, a table with the basic differences between Islamic and conventional banks is provided:

Table 1: Differences between Islamic and conventional banks (Sundararajan, Errico 2002, 31–32)

Characteristic	Islamic bank	Conventional bank
Guaranteed payments on demand deposits	Yes	Yes
Guaranteed payments on investment deposits	No	Yes
Deposit rates	Not defined (and not guaranteed for the investment deposits)	Defined and guaranteed
The mechanism of determining the rate of interest on deposits	Is determined by the profitability of the bank, income investments	Do not depend on the bank's profitability
Participation of investors in the profit and loss of the bank	Yes	Almost no participation
Usage of Islamic financial products	Yes	Mostly no

The right of the bank to decide to grant a loan, depending on the client's profitability	With the participation of investors in the profit and loss statement of the Islamic bank, it often does not have the right to discriminate against clients, depending on their existing collateral	Common practice

2. 2 Structure of Islamic Financial system

The listed institutions create Islamic financial system:

1. Islamic banks - financial institutions that take deposits and carry out investment of accumulated funds, full-fledged research Islamic banks, ancillary banking divisions or the Islamic "windows" of conventional banks.
2. Islamic capital market and its participants, such as broker offices and investment banks.
3. Islamic insurance.
4. Financial institutions excluding banks. These include Islamic leasing and factoring companies, financial companies, housing cooperatives, microfinance institutions, private equity and venture capital funds; institutions related to the worship execution and charity.
5. Islamic financial infrastructure (payment system, screening system, trading and clearing systems, organizations that provide statistical information, educational institutions, control over the observance of standards of financial statements, research organizations, etc.).

According to Jamaldeen, 2012, 23

2. 3 Instruments used by Islamic banks

Islamic banks offer transaction contracts and contracts in which bank acts as a financial intermediary. Transactional contracts are associated with the production of a real sector and include trade, exchange and financing economic activity. Mediation contracts facilitate efficient and transparent execution of transactional contracts (El-Qorci 2005, 45).

As it was said before, the basis of Islamic banking is the participation of the owner in both profit and loss. Thus, the owner receives remuneration for provision of resources only if funded project is profitable. At the same time the principle of participation in the profit and loss account is not used in contracts such as Qardhul Hasan, Ijara and Murabaha, which ensure the provision of funds for the purchase of goods. Such tools are closely associated with risk-taking and do not differ greatly from those used by traditional banks. There are dozens of different contracts in Islamic banking system. The instruments that are commonly used are listed below (Grais, Iqbal Z 2004, 50).

Musharakah

Musharakah is a joint project of the bank and entrepreneur. This product provides the bank and the customer with partnership agreement, under which the parties jointly finance the project. This is an agreement under which the bank pays the customer in a predetermined proportion of the profit gained as a result of business or profits divided between him and the bank in proportion to the participation of the parties in financing the project. Losses are also distributed in proportion to the participation of the parties in the financing. Financing of the project can be carried out by more than two parties, when the project management is carried out by all participants from one of these parties. The advantage of this product is that it allows to make flexible agreements in that particular partnership. Profits can be shared with the distribution and management of forms may be agreed by the parties. In fact, Musharakah is an implementation of the bank portfolio investment in investment projects. Musharakah contracts can be used to recharge current assets of the company or for joint investment activity, such as investments in real estate and agriculture. Often this type of contract is used to finance long-term investment projects (El-Qorci 2005, 46).

Mudaraba

In mudaraba bank, the owner of capital trusts its means for the effective use of the entrepreneur, if the one has the ability, experience and reputation. Moreover, the bank has no right to demand collateral in exchange for cash. Mudaraba is normally used to finance short medium-term investment projects (e.g. in trade). Mudaraba contracts are analogous to the trust fund in the traditional financial system. The resulting income from the invested money is distributed between the bank and the entrepreneur in accordance with the agreement made at the time of signing the contract. In addition, the contract stipulates the proportion in which the profit will be divided rather than specific amounts of money (usually a bank receives 15-30% of the profits). The losses (if they occur) are carried out only by the bank, and the client in this case does not receive remuneration for work and efforts (Al-Jarhi M. A., Iqbal M 2001, 24-28). The daily management of the project does not interfere with the bank. However, the entrepreneur is not entitled to send received from the bank's money on financing of other projects that are not covered by the contract without the permission of the bank. At the same time the entrepreneur cannot attract other sources of funding or use his/her personal money. Entrepreneur’s costs are limited to his time and effort. However, if the negligence and mismanagement of an entrepreneur are proved, he will be responsible for financial losses (El-Qorchi 2005, 47-48).

Mudaraba contracts may be not only directly between the bank and the entrepreneur but also between an investor and a bank. In this case, the investor carries out the function of the bank, and the bank plays the role of the entrepreneur.

It should be taken into concideration that due to the fact that the bank does not require collateral for funds, mudaraba contracts’ risks are very high (El-Qorchi 2005, 47).

Muzara'a

Muzara'a is an analogue of mudaraba used in the agricultural sector. In accordance with a typical contract, the worker agrees to work in the land and cultivate the crop on the host land. The contract prescribes which party provides seeds and equipment. The harvest is divided between the bank and the entrepreneur in accordance with their contributions. In the case of crop failure the owner does not receive benefits from the ownership of land, and the efforts of the working are wasted. An analogue of this contract in the traditional economic system is a sharecropping lease (Sundararajan, Errico, 2002).

Direct investment

The mechanism of direct investment is the same as a similar mechanism in the western financial system. The bank may provide private companies with financing and in exchange for this, depending on the size of its investment in the project, can get some seats on the board and have a say in the management of the company. Investments may be made in various sectors such as industry, construction, medicine, education, etc. However, in the Islamic financial system banks cannot invest in projects that are contrary to the doctrines of Islam, such as gambling, etc. (Čihák, Hesse 2016, 23-24).

Murabaha

Under this contract a bank provides trade finance. Murabaha is accompanied by a contract of sale of goods between a bank and its customer at an agreed price. The Bank buys goods (raw materials, component parts, etc.) on the client's behalf, and then resells goods to him, making a profit from the sale of goods, as well as the margin for services rendered. All the details like the date, place, quantity, the remuneration are stated in contract. There is a possibility of collateral use as a guarantee for the bank. Collateral may be represented in the form of cash and in the form of a mortgage, it may be obtained by the bank at the time of signing the contract or earlier (Čihák, Hesse 2016, 23-24).

Ijara

This product is similar to leasing in the traditional financial system. It provides an agreement under which the bank first buys equipment, real estate, etc. on demand of customer and then leases it to the customer in the lease. The duration of lease and rental fee (a fixed or time-varying)is agreed between the parties. It should be noted that the traditional leasing costs depreciation, insurance and taxes are the lessee's responsibility. Ijara contract in this respect differs from conventional leasing because the lessor bears these costs. However,in Islamic banking, there are mechanisms that can shift these costs to lessee. Ijara contract can be made by banks in order to sell the right to use their property and income for clients for the medium and long term operations (Čihák, Hesse 2016, 23-24).

Qardhul Hasan

Qardhul Hasan is actually an interest-free loan. In case of signing a contract the bank provides the client with a certain amount of money, which the client is obliged to return after a specified period of time. Returning the principal debt, the customer can pay the bank (exclusively at will) a certain amount as a voluntary bonus - Hiba, to cover administrative costs. The bank never requires premium and payment for the contract is not expected. However, as a guarantee that the debt will be returned, the bank may require collateral. The bank cannot take away the collateral in case of bankruptcy or business loss (Ayub 2007, 194).

Sukuk

It can be considered as bonds that meet Sharia requirements. In its simplest form sukuk represents the ownership or lifetime use of the asset and income from it. Sukuk is entitled not only to share in the flow of cash, they also give the right to property. Sukuk differs from traditional bonds, since the latter are simply interest-bearing securities, whereas sukuk - is, in fact, investment certificates confirming the right to share in the pool of assets. However, as long as sukuk is a purely financial securities paper, Sharia treats them as debt. Consequently, many investors in the Islamic countries cannot trade bonds sukuk in the secondary market, as this may cause riba. Because of this limitation, investors tend to hold such bonds until the maturity date. It should be noted that more than $19bn was raised after 30 issues of sukuk bonds on the London Stock Exchange in 2011 (Valdez, Molyneux 2016, 483).

Takaful

Takaful or Islamic insurance is based on a special mechanism of distribution of profits and losses, which is consistent with the principles of Shariah, and therefore meets the needs of the Muslim world. The main objective of Islamic insurance is not just the protection of the interests of unforeseen circumstances by joint participation in losses, but also profit. Because of this, takaful companies can generate more profit than the traditional (Western-style) insurance companies. This object is achieved by a process of shared responsibility, based on the mudaraba model, which is a recognized institute of Islamic economics. Members or policyholders (in the traditional sense) transmit their contributions to the operator or the insurer as a gift for their effective use with the proviso that in case of insured event the money will be returned. Part of the fees go to the accumulation fund. From this investment the participants have the opportunity to receive a regular income in the proportion stated in the contract, which can reach 50 or 60 percent depending on the profit of takaful company. At the same time it is not allowed to invest in shares or assets of companies doing contrary to the principles of Sharia activity: production and sale of alcohol, tobacco, gambling, and some others. Practically, investments which could be made in shares are included in the Dow Jones Islamic Market Index (Valdez, Molyneux 2016, 487).

Istisna

Istisna'a is a derivative that is operating in the Islamic financial system. This banking product was created specifically to finance large-scale and lengthy projects. Calculations are carried out on such a contract at a price set at the date of conclusion of the agreement and the payments are made in pre-defined intervals during the project and its completion (Ansari 2011, 37-39).

One of the features of this type of financing is drawing detailed work schedule (completion date, the amount, quality, etc.) and its strict compliance during implementation. The customer has the right to appoint a sub-contractor (a third party) to perform the work. The parties may agree on the timing of payments, but the amount of the contract shall remain unchanged (Ansari 2011, 37-39).

2. 4 Financing Methods. Assets and liabilities

Islamic banks' balance sheet

Assets	Capital & Liabilities
	Equity
Profit and loss statement modes of financing	**Investment deposits** • Neither the principle nor the return are guaranteed
Trade modes of financing	• Depositors share the bank's net profit according the PLS ratio stipulated in the contract
	• Can be withdrawn only on maturity
	Demand deposits • Yield no return and repayable on demand at par value

Table 2: Islamic banks' balance sheet (Sami Nabi, 2013, 49)

It is possible to open a current, savings, investment or a special investment account in an Islamic bank. Conditions for current accounts of Islamic banks do not differ from the conditions of the opening of such accounts in Western banks.

Interest on the current account is not paid; the customer can get guaranteed repayment any time (Ansari 2011, 35-36).

Owners of savings accounts are not allowed to participate in profits, but the bank in order to attract depositors can pay a premium depending on their profitability. Savings deposit is not urgent, and the return of its main part is guaranteed by the bank. Funds raised by banks on savings deposits are invested in low-risk operations, as a rule, in the financing of commercial transactions. The unlimited investment accounts could be opened be the depositor. In that case the depositor can give the bank freedom to invest money in any business according to Shariah. In the limited investment accounts the bank usually combines its own savings and investors' savings and shares the profit between investors and itself. This is called the principle of profit and loss (mudaraba). Note that income received by investors, as a rule, is comparable to the percentage in conventional banks (Askari, Iqbal, Mirakhor 2014, 196).

Islamic bank assets have a large selection of options for investing. Short-term investments with limited risk can be made by entering the type of murabaha contracts. Such tools give the bank opportunities to provide short-term loans to its customers. At the same time, short-term maturity and security of real assets minimize the risks. Medium-term investments based on contracts Ijara and istisna are also provided by real assets. Thus, many contracts are assessed on Islamic financial system, allow Islamic banks to carry out the whole range of traditional banking operations and maybe some extra options. It is clearly seen that the risks of the Islamic banks are extremely low and they must be ones of the most sustainable institutions. Nevertheless, every system has issues and Shariah based banks have some weak points as well (Valdez, Molyneux 2016, 267).

3. RISKS IN ISLAMIC FINANCE

In Islamic financial system exist some obstacles that usually prevent people from cooperating with those institutions. The key risks which can also be disadvantages are additional regulatory complexity; additional risks inherent in the banking system, based on the division of responsibility (investors bear the risk of loss on a par with the bank), need to monitor the transparency and legality of the operations (IRTI, IFSB 2016, 24).

Opportunistic behavior is a big risk for any Islamic bank. Explanation is the simplest: in case of mudaraba, the project invested by a bank might turn out to be unprofitable and the bank may not get back the money given out in loan. The client may even try to hide from the bank the real incomes for projects under implementation. That is, in this case the Islamic bank risks are much more substantial than the risks of the usual bank (IRTI, IFSB 2016, 24-26).

According to Pervez, 2001, currently there are no uniform standards for reporting in Islamic banks. As a result, there are no standards for the accounting of different operations. Moreover, new types of contracts keep popping out making an inspiring amount of different interpretations. In such circumstances, standardization of Islamic financial instruments is a challenge. It should also be noted that Islamic banks have almost no hedging tools. Sharia is against riba (interest payments) and some questions of Islamic jurisprudence concerning the interpretation of gharar (excessive risk), lead to the fact that many of the hedging instruments based on generally accepted mechanisms, such as options, futures and forwards, at the present level of development are not available (Pervez 1990, 259–281).

Those were a few, but definitely not all of the risks faced by Islamic banks and it seem to be reasonable for the banks to have special environment that protects them from losses and stressful situations (Pervez 1990, 259–281).

Nevertheless, audit and controlling in Islamic banks is really strict. The decisions about bankruptcy can be only made collectively. Most of the cases are carefully investigated by independent commission. In special cases bank can even force the client to return the loan. After this the client gets a place in “blacklist”. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), The Islamic Financial Services Board (IFSB) are two main organizations who set the standards for Islamic banking and also have their influence in the world’s economy (Pervez 1990, 259–281).

3. 1 Regulation of Islamic banks

3. 1. 1 Development of legislation

For the normal functioning of the Islamic banking system it is crucial to develop legislation based on Sharia, which specifies in detail the working conditions as a normal commercial bank, and special features that are specific to Islamic financial institutions. The terms of the license must be carefully negotiated; there must be a valid funding model as well. Rules of law and regulation techniques needed to be clearly established. In addition, it should be clearly stated in the law exactly when an organization can call itself an Islamic bank and carry out banking activities in accordance with Islamic principles (Chapra, Khan 2000, 22).

Nevertheless, at present, in many countries legislation is not properly developed. Legislation to facilitate the functioning of the Islamic financial institutions exists only in some countries. Many Islamic banks operate in countries with western forms of organization of economic life (for example, Malaysia and Kuwait), and Islamic banks operate under the supervision of the central banks of these countries (Chapra, Khan 2000, 23).

At the same time, Islamic financial institutions in the traditional financial systems are inferior to the competitiveness of traditional banks. For example, in most of the countries, the Islamic financial contracts related to real assets are considered as the purchase and resale. Therefore those contracts are being a subject to more tax compared to ones made in traditional banking. In many countries interest rates on deposits and loans are not under taxation, while in the implementation of similar Islamic contracts are. However, in some countries such as Singapore and the United Kingdom, taxation for certain Islamic contracts is similar to the taxation of traditional banking instruments (Chapra, Khan 2000, 24).

Leaders of development level in the Islamic financial sector, such as Bahrain and Malaysia, could create legal and economic conditions, taking into account the characteristics of Islamic banks and allowed to maintain the existence of a mixed banking system (Chapra, Khan 2000, 24). It is important to give the Islamic institutions certain conditions for growing from both legal and Islamic perspectives, at least to accept their banking activity on legal level or, for example, to use mandatory reserves of Islamic banks in the central banks in accordance with the requirements of Shariah (Chapra, Khan 2000, 23). In the area of bank capital adequacy regulation at the international level, important progress was made in 1988, when the Basel standards were adopted and international standards for capital adequacy were set and widely used in the world (Chapra, Khan 2000, 24).

A mandatory requirement for traditional banks is a guaranteed return of the principal amount of bank deposits. As it has been described in previous chapters, in the Islamic banks the return of the principal amount of the deposit are also allocated in investment accounts, on which it is impossible to guarantee the repayment of the principal, because the investment is associated with financial risks. In this regard, the Islamic banks often have problems with the supervisory authorities (Chapra, Khan 2000, 24–25).

How can such a problem be solved? Bank Al-Baraka (Saudi Arabia) did it really well. The tools were deposit insurance scheme, depositors' funds were invested according to murabaha model in certain sectors where the return of the invested amount has the biggest chances to be returned and profitable, and used a number of other mechanisms (Chapra, Khan 2000, 25).

As it was said before, there are some organizations whose activity is aimed at the establishment of standards for financial reporting (AAOIFI, IFSB). Standards developed by this organization, adopted by many Islamic financial institutions. For example, some banks are considering investment accounts as off-balance sheet commitments, which reduce the requirements for the size of their capital. Therefore AAOIFI requires such accounts to be reflected in the bank's balance sheet. Due to the fact that the size of the bank shows its stability, in some countries, such as Turkey, Pakistan, Sudan, Indonesia, the government requires banks to increase capital or to carry out a merger for increased reliability (Chapra, Khan 2000, 24).

All in all, during the process of pursuing economic policy some factors should be taken into account. Optimal value depends on capital, including the composition and the bank's asset portfolio. If the portfolio is made of risky contracts (Mudaraba, Musharaka) the requirements for capital should be stricter. At the same time, if a portfolio has more contracts such as the Ijara, istisna, murabaha (low risk contracts), then capital requirements should be lower (Chapra, Khan 2000, 24).

3.1. 2 Monetary policy under the conditions of Islamic financial system

Because of the prohibitions imposed by Sharia on transactions using the rate of interest, there is no availability of refinancing the services provided by the central banks to the usual, limited Islamic financial institutions. The task of establishing mechanisms for the implementation of monetary policy in this situation is particularly difficult (Sundararajan, Errico 2002, 16).

Nevertheless, at the present time in order to regulate banks' liquidity, some Islamic countries issued government securities, which circulation rules are agreed with the Islamic jurists. For example, the Central Bank of Iran produced national participation certificates that are used to finance public investment projects. These securities do not have a particular interest rate, and rate of return on them is determined on the basis of stock market returns. In Sudan, the central bank issued securities based on Musharaka model (Sundararajan, Errico 2002, 16).

3. 1.3 Hawala system and money laundering

The system is based on the hawala money transfer through multiple notification and confirmation by e-mail, fax or phone calls. Recently, Skype was used as the most confidential method of communication. Wealth in the form of money, gold and precious stones is moved from country to country without any supporting financial documents. All the financial transactions are carried out in the course of swap operations (by offsetting) or in person (the second case, much less), so the government is not able to keep track on the flows (El-Qorchi 2002).

Hawala is attractive to customers who need quick and easy transfer of money, usually with much lower commission than charged by banks and official money transfer systems (El-Qorchi 2002). Based on complete trust, it does not require identity cards, which is important for people working illegally. Translation of hawala leaves no evidence because each operator uses its own accounting system: someone keeps everything in memory, and someone uses the icons, the true meaning of which is known only to him (El-Qorchi 2002).

In particular, in practice there is no reporting on hawaladar in market transactions. This causes suspicion of the authorities in Europe and America, who see in this system a convenient mechanism for secret financing of any illegal activity, whether drug trafficking or terrorism (El-Qorchi 2002).

All in all, after getting familiar the main principles of the functioning of the Islamic financial system, it can be considered that most of the Islamic financial contracts are not based on economic reasons but on Islam. Apparently, almost any Islamic financial instrument has conventional analogue, the implementation of which is simpler and requires less transaction costs (IFSB 2014, 23).

At the same time, there is reason to believe that in countries with a large Muslim population people are not ready yet to trust their savings to traditional banks, (as well as in the countries with a significant number of Muslim entrepreneurs who do not use the services of traditional banks), the development of Islamic financial institutions can increase the efficiency of the financial market and speed up its development (IFSB 2014, 3).

The beginning of the development in the US and Western Europe allows us to assume that Islamic financial institutions will arise and spread in Western Europe as well as in Russia. European organizations that do Islamic banking have the same problems as the traditional ones had at their beginning. Germany is the case that shows how Islamic banks can deal with high risk with the large population of Muslims creating a financial equilibrium (IFSB 2014, 3).

The functioning of the Islamic financial institutions in Europe (including Russia) means the changes in legislation, innovation, financial knowledge of the population. It is becoming more complicated when talking about adjustments in monetary policy and the maintenance of stability of the financial system. In such a situation it is necessary to know the features of their operation and the risks that they bring to the national financial system. Nevertheless, before considering the possible issues of opening Islamic financial institutions in the west, some geographical facts are going to be discussed in the following chapter (IFSB 2014, 23–25).

4. PROPAGATION OF ISLAMIC BANKING SYSTEM

The development of the Islamic banking system only began in the second half of the 20th century in the Muslim countries due to significant proportion of residents who refused to use the services of traditional banks. Islamic economists created a new system of banking. The first Islamic financial institution appeared in the 1960s in Egypt. Savings Bank of Mit Ghamr, opened in 1963, began to carry out operations and invest in the accumulated resources. Nevertheless it looked more like a thrift institution, not a commercial bank. The first commercial bank operating under Islamic principles, Nasser Social Bank, was founded in 1971 in Egypt (Askari, Iqbal & Mirakhor 2010, 1–3).

Due to the oil crisis in 1973 Islamic banking system started to develop especially rapidly when a sharp rise in oil prices led to a large increase in export revenues in the Middle East. In the 1980s the main goal of Islamic banks became standardization of financial products due to lack of development of the Islamic capital market which was a problem for efficient investment (Askari, Iqbal & Mirakhor 2010, 1–3).

Currently, Islamic banking is in demand, firstly, in Muslim countries: in the South, Southeast and Central Asia and Africa. But now, in addition to the countries from these regions such organizations can be found in Europe, the USA and Australia. In Iran, Pakistan and the Sudan, the financial system is entirely subordinate to Islamic norms, and all the banks in these countries are Islamic. In Muslim countries such as Malaysia, Indonesia, the United Arab Emirates, Saudi Arabia, Brunei, there are two types of banks, both traditional and Islamic (Askari, Iqbal & Mirakhor 2010, 1–3).

The clients of Muslim financial institutions are mostly Muslims (about 1.6 billion people around the world). However, interest in investment from the Middle East is already showing representatives of other religions. Islamic banks resorted such multinational giants as General Motors, IBM, Alcatel, Daewoo and others. Islamic financial sector is growing rapidly with average growth rate of 10-15%

per year. Standart & Poors rating agency assigns Islamic banks high-profit category (Bricault 1991, 435–437).

Muslim population increased from 10 million in 1990 to around 17 million in 2010 in Western Europe which means that Europe has been adapting to those changes and opening more places where people can operate under Sharia rules (Islam 2015, 1–3).

Before beginning with the next topic should be mentioned that one of the major problems faced during the research was the lack of statistical information about the industry. That means the numbers might be not exact but at least as close as possible.

4. 1 The scope and geography of the Islamic banking system

According to the report of Council for Islamic Banks and Financial Institutions (CIBAFI) for 2005 in 38 countries operated 284 Islamic financial institutions. Their assets totaled about $ 250 billion (this is without operations of Islamic banking "windows" offered by conventional banks, as well as the operation of non-bank financial institutions and investment companies). In 2006, the size of the collected insurance premiums reached $ 20 billion (Harvey 2015).

4.1. 1 Muslim countries

In the 70 – 80s of 20th century in Muslim countries emerged the first major Islamic banks, such as Dubai Islamic Bank (UAE), Faisal Islamic bank of Egypt, Faisal Islamic Bank of Sudan. In addition to the largest Islamic banks of Muslim countries are Abu Dhabi Islamic Bank (UAE), Faisal Islamic Bank of Egypt

(Egypt), Al Rajhi Banking & Investment Corp (Saudi Arabia, have branches in Malaysia), Shamil Bank of Bahrain (Bahrain). In the Gulf states as local investment banks operate First Islamic Investment Bank (Bahrain), The International Investment Bank (Kuwait). International banks also offer services consistent with Islam (so-called Islamic "windows" of conventional banks) such as HSBC, UBS (mainly in Bahrain, and the UAE). Citibank also cooperates with Islamic banking institutions for a long time. It should be noted that Islamic financial institutions operate in some Muslim countries, such as Saudi Arabia, UAE, Qatar, but there is virtually no information on their operations (Harvey 2015).

4.1. 2 Developed countries

The first Islamic bank in the West Islamic Banking System (Now - Islamic Finance House) appeared in 1978 in Luxembourg. A group called Dar Al-Maal Al-Islami was also based in Geneva (Unknown 2005).

Known global banks such like HSBC, DeutscheBank, Calyon, Citibank, Standard Chartered, BNP Paribas, ING bank, Chaise Manhattan Bank, Goldman Sachs, The Nomura Securities, JP Morgan, Lloyds TSD and others opened Islamic finance division in their open structures for their clients not only in Islamic countries but also in the US, UK, Germany, France. Deutsche Bank launches sukuk bonds and works on creation of Islamic hedge fund (Harvey 2015).

Great Britain

The Arab community of London is one of the most meaningful in the world, because of the high concentration of Muslim enterprises, especially small businesses. London has its own Arabic mass media and press. Muslim residents and newborns reached the number of 2 million and this number is growing surely. The average Muslim family being twice as large as the average family size in the United Kingdom and there are over 350 thousand of households (Islamic Banker 1997, 2–3).

Although, the first Islamic bank Al-Baraka in England, London did not succeed in 1900s because of the tightening of the requirements and standards of the Bank of England. After that, conventional banks like Citybank had “windows” of Islamic banks as well as there were services of mortgage lending based on Sharia (New Horizon 1993, 7–8).

UK authorities' attitude to the Islamic banks has changed for the better. After the start of the Financial Services Authority (FSA), has control and supervision over the financial sector, the UK authorities represented FSA became more constructive attitude to the idea of an independent institution of the Islamic bank in the UK, which would He acted within the existing banking legislation along with traditional commercial banks (New Horizon 1995, 2–5).

The United States of America

The number of Muslims living in the USA is growing rapidly that’s why Islamic financial institutions and institutions that offer non-bank mortgage and Islamic financial products have big popularity there. The largest concentration of Islamic financial institutions is observed in areas with a high proportion of the Muslim population - Chicago, New York, Northern Virginia, Minneapolis, Southern California and others. The most known institutions offering Islamic financial services in the United States are HSBC, Larina Finance House; University Bank in Ann Arbor, Michigan, and Devon Bank of-Chicago (Bachmann 2002).

Russia

At the moment, there are no Islamic financial institutions in Russia. Current legislation makes the operation of Islamic banks almost impossible. Badr-Forte Bank was the only Russian trying to work on Islamic principles, but in December

2006 the Central Bank of the Russian Federation withdrew its license due to nonperformance of federal laws regulating banking activities, as well as the Bank of Russia regulations and the violation of the requirements stipulated by the law "On counteraction to legalization (laundering) of proceeds from crime and terrorist financing" (Seleznev 2015).

Although, according to the latest news, at the end of March 2016 in Kazan, there will be the first banking center of a partnership that works on the principles of partnership agreement which is widespread in the Middle East and Southeast Asia (Seleznev 2015).

In October 2015 the Central Bank of the Russian Federation has created a working group to study the regulatory and institutional arrangements and capacity to provide Islamic banking services in Russia, reports "Interfax". This event will definitely create some opportunities for the supply of financial services and become a reason for investments in Russian Federation (Habibrahimov 2016).

To summarize the facts, the role of Islamic banking increases rapidly in global financial system. Thus, traditional Islamic finance products are able to be adapted so that they can relatively easily be offered also by conventional banks. However, often the output of Islamic banks on traditional banking market is associated with certain difficulties, due both to the adaptation of the banks themselves and the legislative regulation of the banking activity. In the next chapter the problems of Islamic financial institutions in the traditional financial markets will be considered.

5. ISSUES AND POSSIBLE SOLUTIONS OF ISLAMIC BANKING IN THE WORLD OF CONVENTIONAL FINANCE

In the previous section it was shown that the current Islamic banking is being implemented in the traditional financial system not only in countries where the Muslim population predominates, but also in countries where Muslims are a minority (for example, in the UK and the US). Due to the increase of the Muslim population in Western countries, as well as increase the interest of Islamic investors in the geographical diversification of its investment portfolios, traditional banks' interest to entry the market of Islamic financial products also increased. Despite it, often, the government and the banking supervisors are not well aware of the functioning of the Islamic financial principles institutions (Unknown 2009).

Over the past decade the rate of Islamic banking assets growth was around 10-15% per year, and this trend is more likely to be like that in future. However, despite this rapid growth, the process of introduction of Islamic banking in the traditional financial system is not sufficiently clear and transparent. Anyways, as international experience shows, sooner or later, the domestic financial system will face such institutions.

After analyzing the risks, regulations and propagation of Islamic banking, the following questions can be answered: What kind of obstacles does the process of the implementation of Islamic finance take? What questions will be faced while that implementation?

Compliance with Sharia law

Islamic financial institutions operate under the principles established by the laws of Sharia, as well as other legal acts, which are published by experts in Islamic law. Some of these standards can be difficult to interpret, which shows the necessity of the experts to correct interpretation of the documents. As a result, there is a very common practice of establishing special council of experts by Islamic banks.

Thus, from the point of view of Islamic law, it is absolutely necessary to attract the expert or group of experts involved in the audit of financial products in compliance with Sharia law, before making a decision about the beginning of trading of Islamic financial products. This step is the introduction of Islamic financial products.

Moreover, risk management is another important detail. Operating in accordance with the principles of Sharia brings to the work of Islamic financial institutions additional risks as the risk of compliance with the principles of Sharia, legal risks, and so on. Therefore, Islamic banks will be forced to spend additional funds for the establishment of a risk management system.

As for Russia, it may be worthwhile to introduce a separate type of license, specifically for Islamic banks. At present, a key obstacle to the development of Islamic finance in Russia, most likely, is the Law 115-Federal law "On counteraction to legalization (laundering) of proceeds from crime and terrorist financing" (Seleznev 2016).

Standardization

At the moment, there are no common standards of financial reporting and the regulatory framework for Islamic financial institutions. That means, a country should choose in accordance to which standarts will the Islamic institutions there work. It could be AAOIFI standards (Accounting and Auditing Organization for Islamic Financial Institutions), or standards developed exclusively for particular country, like it is done in Iran.

HRM

Skills in the field of Islamic finance in the staff of financial institutions are a big part of a problem as well. Islamic banking on the traditional finance area also is seeking for experts versed in financial matters. Currently, there are almost no specialists like that. There are experts in the field of banking, but usually they do not know the Islamic principles, or there is Sharia experts, but they have never worked in the financial field. The solution could be recruiting experts from Middle east or creating special institutions which could prepare such specialists.

Awareness of the population

The main obstacle for the development of Islamic banking is all, above all, the mentality of the population and the level of financial literacy. People have become accustomed to the classical banking system. The individual segments of the population (non-Muslims) would probably be interesting to use this type of savings, as the client in this case realizes that his money is on the development of a particular company. The speed and success of the development of Islamic banking largely depends on the awareness of potential customers and investors about the possible risks and the level of transparency of the activities of the Islamic bank.

It is obvious that investors are more aware of the conditions functioning of traditional banks, rather than on the conditions of deposits in Islamic banks. Consequently, supervisors should provide information to economic agents of Islamic institutes and products, as well as demand from financial institutions to offer Islamic products and conduct awareness campaigns that explain the core aspects of Islamic financial institutions.

Safety of the clients

Islamic banks should provide customers with the same level of protection as traditional banks provide their customers. People involved in demand deposits in Islamic banks, and entities engaged in similar deposits in conventional banks, faced with the same risk, and, therefore, require the same degree of protection.

It should be noted that the risk of dishonest behavior can be partially reduced by increased competition in the banking sector, as a competition between Islamic banks creates the desire of banks to minimize losses, are passed on to depositors in order to retain and attract customers. In practice, banks have resorted to the creation of reserves for investment risks to protect its depositors.

It should be noted that all of the issues (excluding the additional costs of adapting software) might lead to the rise in price in Islamic financial services compared to traditional, but only during the adaptation period.

6. CONCLUSION

Islamic banking gained its popularity due to its balanced relation between the bank and customer through risk and profit sharing instead of completely making the risk a responsibility of the client. It is a not closed system and gives opportunities to everyone to prosper in the society.

Going through the principles of Islamic financial institutions showed that most of the features of Islamic financial contracts are not economic, but technical and they need to be adapted to Islam. Apparently, almost any Islamic financial instrument has conventional analogue, the implementation of which is simpler and has less transaction costs. A serious question about the necessity of the emergence of Islamic financial institutions in the traditional financial system arises in such a situation.

Despite all the issues and obstacles which Islamic banking has, it is obvious that the current trends in the development of Islamic banking will remain as oil-exporters countries continue to receive significant revenues. The financial markets of Islamic countries continue to develop, and Western companies are competing to attract foreign investors. All this creates conditions for a thorough examination of the functioning of Islamic banks and their entry into the traditional financial markets as long as growing of Muslim population in non-Muslim countries.

In addition, a number of advantages of Islamic banking should be noted. Those are conservativeness in the choice of instruments and involvement in the client's business. That is, these two factors have allowed Islamic banks to pass the crisis without the shocks that befell the traditional banks. Islamic financial institutions are more resilient. Thus, the global crisis of 2008 - 2009 had hardly touched Islamic financial institutions. IMF, conducted in 2010, a comparative study on the impact of the global crisis on the Islamic and conventional banks, came to the conclusion that Islamic banks have shown more consistent results than the traditional, and even during the crisis showed steady growth of about 15% per year.

On the one hand, the lack of interest loans tightens up inflation and investment risks. On the other hand, it has a moderating impact on the investment activity. The result is stable in the long run the economy, which, however, in a relatively short period of time can look less attractive than Western economic model in terms of growth. However, in long run perspective, Islamic banking is much more pragmatic (Zaripov 2014).

Thus, Islamic financial institutions, developing in the future will create a healthy competition to traditional financial companies and banks, and promoting further comprehensive development of the domestic banking system and the financial sector as a whole.

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