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## ISLAMIC FINANCE: PROBLEMS RELATED TO THE INTRODUCTION AND THEIR SOLUTIONS.

**Abstract:** In this article, causes for the introduction of the Islamic finance have been analyzed and current related issues have been identified as well as demonstrating their solutions. In order to obtain the aim of the article several legal and theoretical-scientific sources have been studied. Particularly, experience of numerous countries of the world has been comparatively analyzed and special characteristics in terms of following main principles of the Islamic finance have been identified. Especially, the article reveals the differences and economical nature of Islamic and traditional bank activities relatively as well as determining directions in implementing it and providing recommendations for using positive aspects of its implementation.

**Keywords:** Islamic finance, Islamic banks, takoful, usury, cave, maysir, islamic windows, risk distribution, profit and risk distribution, dualistic model, real assets.

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## ИСЛОМ МОЛИЯСИ: ЖОРИЙ ЭТИШ БИЛАН БОҒЛИҚ МУАММОЛАР ВА УЛАРНИНГ ЕЧИМЛАРИ.

**Аннотация:** Ушбу мақолада ислом молиясини жорий қилишга сабаб бўлган омиллар таҳлил этилган, уни ташкил этиш билан боғлиқ долзарб масалалар аниқланиб, уларнинг ечимлари баён этилган. Мақолада қўйилган мақсадга эришиш учун бир қанча ҳуқуқий ва назарий-илмий манбалар ўрганиб чиқилган. Хусусан, Ислом молиясини жорий этиш борасидаги жаҳоннинг қўплаб мамлакатлари тажрибаси қиёсий таҳлил этилган ҳамда ислом молиясининг асосий тамойилларини амал қилишдаги ўзига хос хусусиятлари аниқлаб берилган. Айниқса, мақолада замонавий ислом ва анъанавий банклар фаолиятидаги фарқли жиҳатлари ҳамда иқтисодий моҳияти қиёсий тадқиқ этилиб, уни амалиётга жорий этишдаги йўналишлари аниқланган ҳамда ижобий жиҳатларини амалиётга қўллаш юзасидан тавсиялар шакллантирилган.

**Таянч сўзлар:** ислом молияси, ислом банклари, такофул, рибо, ғорар, майсир, ислом дарчалари, хатарларни тақсимлаш, фойда ва зарарни тақсимлаш, дуалистик андоза, реал активлар.

### Introduction

Global crisis of finance system relating crisis of sectors in financial market, the attention of World investment community to Islamic forms of financing has increased noticeably. The fact that the Islamic financial sector is one of the fastest growing sectors in the world in modern conditions has also increased attention to it.

The new economic policy currently emerging in Uzbekistan requires a reconsideration of the direction of economic development of the country, the search for new economic partners.

In our country, where more than 90% of the population is Muslim, the demand for Islamic finance is very high. At present, a number of efforts are being made in

our country to introduce Islamic finance and create a legal framework. In his address to the Parliament on December 29, 2020, the President of the Republic of Uzbekistan Sh. Mirziyoyev said that it was time to introduce Islamic finance in the country, involving experts from leading international financial institutions such as the Islamic Development Bank [1].

This issue was also discussed in the lower house of the Oliy Majlis within the factions. At the initiative of the faction of the Democratic Party "Milliy Tiklanish" a roundtable discussion was held on "Prospects for the implementation of the Islamic financial system in Uzbekistan and the creation of a legal framework." During the event which was attended by deputies of the lower house, members of relevant ministries and committees, economists, experts and specialists in the field, the history of the Islamic finance, its current state, the need for Islamic financial service in Uzbekistan and issues related to the need to create its legislative and legal framework were discussed. Islamic finance experts presented the results of a survey on Islamic finance in Uzbekistan and outlined issues related to the opening of "Islamic windows" [2].

Islamic finance is a form of financial activity based on Sharia law. Although the principles of Islamic financial activity were established centuries ago in religious and jurisprudential sources, the concept of "Islamic financial system" is relatively new and began to be used in scientific sources in the mid-1980s. [3].

Demand for Islamic financial services is growing in the world steadily and emerged from crises with less impact. Between 2000 and 2013 alone, the Islamic financial market increased 11-fold. [4].

Islamic finance agreements are formulated in accordance with Sharia law, which prohibits all forms of investment that violate Sharia law. The established strict criteria do not negatively affect the profitability of the portfolio of Islamic financial institutions [5].

At the same time, the lack of institutional, legal and organizational mechanisms for the establishment of Islamic financial institutions in our country creates a number of obstacles to the start of practical action in this regard.

### **Literature review**

There is a significant experience in the introduction of Islamic finance in world practice, and researchers, in particular, Gambeeva Yu.N[3], Zaripov I.A[4], E. Baydaulet [6], ON Mozgovoy and others [7], S. Khorun [8], Juravlyov A. Yu [9], Beckin R.I. [10], Archakova-Ujakhova M.B. [11] elaborated on this issue in their research. At present, the works of S. Harun, E. Baydaulet and R. Beckin on Islamic finance and economics have been translated into Uzbek and published.

E. Baydaulet's research shows the history of Islamic finance, its place in the world financial system, its significant position not only in Muslim countries, but also in the financial markets of developed Western countries.

R.I. Beckin's research is extensive, and his research covers the activities of the Islamic economy, in particular, Islamic financial institutions, which are its largest branch.

The scientific approaches of ON Mozgovoy and others show the basic models of the Islamic financial industry and critically evaluate its mechanisms of operation in comparison with traditional finance. The evolution of Islamic finance and its institutional foundations have been studied.

In his research, IA Zaripov expresses his views on the development of Islamic finance as a solution to the financial problems caused by the economic sanctions imposed on the Russian Federation and the economic crisis associated with the decline in export prices.

The scientific articles of Yu.N.Gambeeva, S.N.Medvedeva discuss the basics and development trends of the Islamic financial system, the rules of operation of the Islamic financial system and the financial instruments used in the Islamic financial system. Different aspects of Islamic and traditional banking are analyzed. Special attention is paid to the development prospects and problems of the Islamic financial system.

The main reasons for the popularity of Islamic financial institutions are their reliance on ethical aspects that are radically different from traditional forms of financing, their involvement in social responsibility and charity, and the stability and stability of Islamic financial institutions during the financial crisis due to strict financial discipline.

### **Research methodology**

In the course of the research, the researches of foreign and domestic scholars on the current position of Islamic finance were studied and generalized. Methods such as analysis, generalization, theoretical observation, comparison were widely used in the preparation of this article. Conclusions and recommendations on the principles of Islamic finance, the problems of its involvement in the national financial system and their solutions were formed.

### **Analysis and results**

Organizational mechanisms of economic activity are based on rules that represent its components. Here, the analysis of the basis of Islamic finance activity, in other words, the principles that its participants follow and apply, is a priority. The principles that Islamic finance entities must follow can be divided into two groups:

1) The main principles of Islamic finance, which are expected to be integrated into the country's financial system, are:

- Absence of usury, uncertainty, gambling;
- ethical conduct of business;
- activities based on real assets;
- inviolability of contracts and protection of property rights.

2) The general principles of the formation of the Islamic financial model are as follows:

- the principle of risk distribution;
- the principle of profit and loss distribution;
- money - considered as "potential" capital;
- Prohibition of interest on loans;
- Prohibition of speculative practices.

The group of principles mentioned above, as a legal basis, is firmly established in the legislation and internal documents of Islamic financial institutions and is the basis for the rules of organization of economic activity.

Although the purpose and duration of the institution's activities are ensured through profit, due to the principles established for its implementation, the practical characteristics of traditional and Islamic financial institutions differ, often reflecting contradictory aspects. Comparing the activities of traditional and Islamic banks, we can observe the following situation through the data in the table below:

Features	Islamic bank	Traditional bank
The position of moral values and religious traditions	The rules of faith are followed	Material interests take precedence
Use of interest	No	Available
Speculative nature of operations	No	Available
Transactions with securities	Passive	Active
Major projects	related to Investment	Related to credit
Borrower evaluation criteria	Ethical	Financial
Level of social orientation	High	Low
Guarantee of profit to investors	The rate of return is not guaranteed, it depends on the success of the project	Guaranteed profit in the form of interest
Principle of profit and risk distribution	Reliability and profitability of the project	Borrower's creditworthiness

Every form of financing in an ethical (Islamic) system creates added value in reality. Ordinary interbank loans, in reality, create an additional money supply that increases beyond a small turnover. This gap between the money supply and the real sector increases inflation, which leads to a decrease in the value of the currency due to the mismatch, which in turn affects the prices of cheaper "goods", raw materials and services, expressed in unsecured paper money [6].

There is considerable experience in the implementation of Islamic finance in the world practice, and researchers have noted that Islamic financial institutions can operate in several forms [7]:

- Full Islamic institutions: Islamic Bank of Bangladesh (Islami Bank Bangladesh Ltd), Mezon Bank (Meezan Bank) (Pakistan) and others;

- “Islamic windows” in traditional financial institutions: Commercial Bank of Dubai, ANZ Grindlays, Commercial Bank of Saudi Arabia, Ahl United Bank of Kuwait, Riyadh

Bank (Riyadh Bank), Hong Kong and Shanghai Banking Corporation (HSBC), Chase Manhattan, BNP Pariba (BNP - Paribas), American Express Bank, Kleinwort Benson and others;

- Islamic subsidiaries of traditional financial institutions: City Islamic Investment Bank (Bahrain) - a subsidiary of Citibank, Noriba Bank - a subsidiary of UBS, etc.

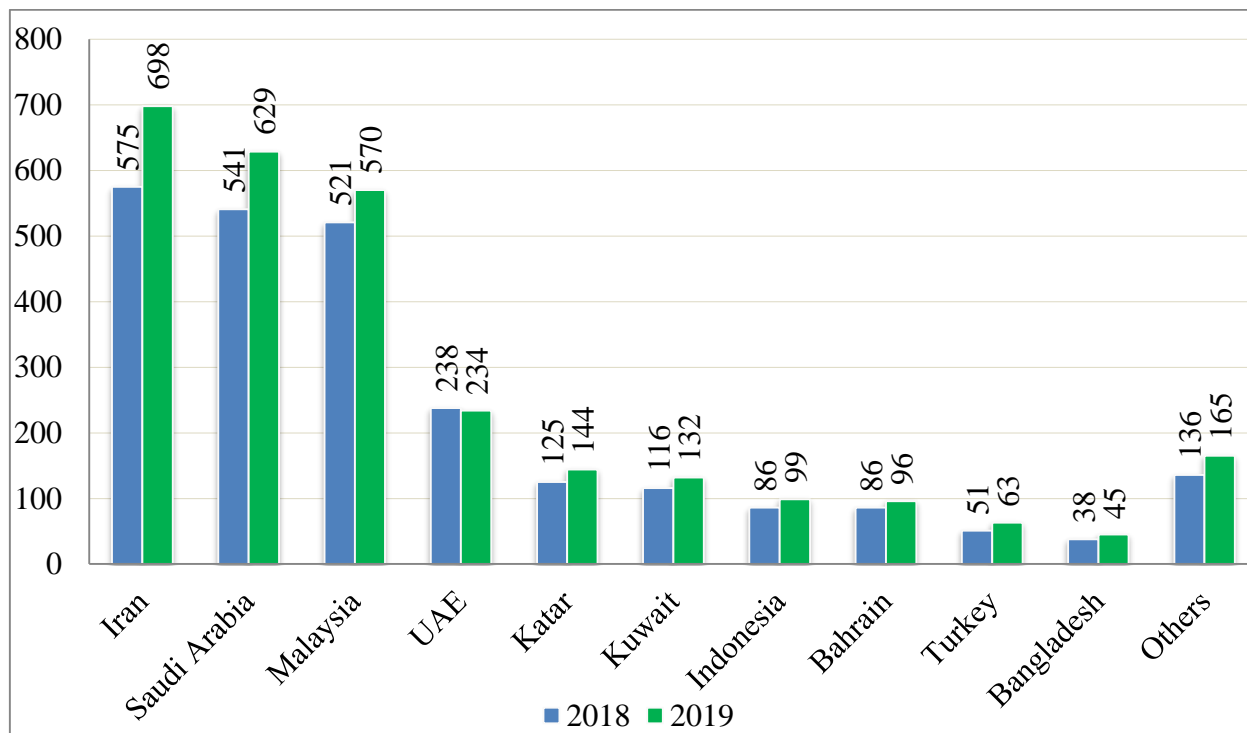


Figure 1. Distribution of Islamic financial assets by countries (USD 1 billion) [8].

According to the distribution of Islamic financial assets by country, in 2019 Iran will receive 698 billion. In US dollars, it owned 24.3% of total assets (Figure 1). These figures are 629 billion, respectively, in Saudi Arabia. USD (21.1%), in Malaysia - 570 bln. USD (19.8%), in the UAE 234 bln. USD (8.1%) and 144 bln. USD (5.0%).

The presence of Islamic banks in Western countries is not surprising. In different years, financial institutions have been established in countries such as the United States, the United Kingdom, and Australia to establish Islamic banking services[9].

In the United States, Islamic banking has been introduced not only by financial institutions, but also by educational institutions. There are more than 20 financial institutions in the United States that provide deposit, financing, and fund management services. There are also educational institutions that allow you to complete courses and seminars on Islamic finance. For example, Harvard University holds annual forums on Islamic finance. Founded in 1987, the American Finance House LARIBA (LARIBA) is one of the leading financial institutions in the United States and currently operates in 35 states in the United States. LARIBA offers housing lending, small business and trade finance services. ([www.lariba.com](http://www.lariba.com))

The first Islamic bank in the United Kingdom, the Islamic Bank of Britain, began operations on 6 August 2004. Accordingly, 1.8 million British Muslims were able to conduct

their banking operations at the expense of established branches. ([www.banking-business.com](http://www.banking-business.com))

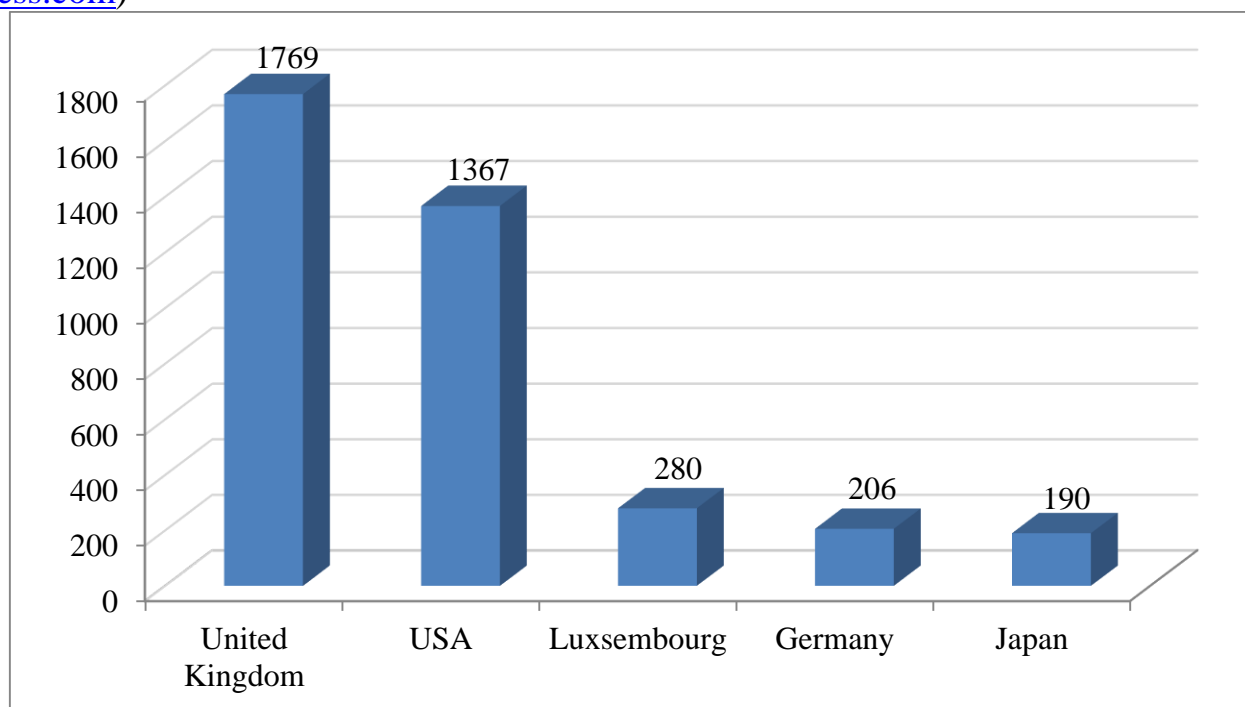


Figure 2. The volume of sukuk emissions in some developed economies of the world (million US dollars) [10].

In recent years, the Islamic finance sector in the UK, in particular the Islamic securities sector, has been developing rapidly. In 2013-2020, the volume of sukuk emissions increased by an average of 35% per year. The fact that one of the few Islamic finance hubs in the world has been established in London today confirms the above ideas.

Another group of economists in their research divides the countries that have tried to establish an Islamic financial system into three groups:

1) Countries with a monistic model (Iran, Pakistan, Sudan) whose Islamic finance and banking practices are in line with the requirements of Islam as a whole.

2) Dualistic (joint) model states in which traditional and Islamic financial institutions operate in the same legal field. In this case, two laws may apply. They are given in the form of a special section in the General Law on Banking or in the normative documents for traditional and Islamic financial institutions of the financial and banking sector (Bahrain, UAE, Indonesia, Malaysia, Kazakhstan, Tajikistan, Kyrgyzstan, etc.) [11].

In addition, it can be said that in countries such as Saudi Arabia, Egypt, Senegal, a single regulatory system applies in the presence of Islamic and traditional banks.

3) Countries that follow the traditional model and do not recognize the legal status of Islamic financial institutions (UK, USA, Russia).

In this study we study, we consider a dualistic or mixed model. Leading economists around the world have shown in their research that this model is effective in a number of countries where Islamic finance has been introduced.

This method of introducing Islamic finance has been introduced in neighboring Kazakhstan, Kyrgyzstan and Tajikistan.

The characteristics of this model are reflected in the following factors:

- 1) The state provides political and other assistance to Islamic banks and other institutions;
- 2) The traditional and Islamic finance sectors will coexist;
- 3) The activities of Islamic financial institutions are, as a rule, regulated by a special law.
- 4) Traditional banking and insurance companies offer Islamic finance products to customers, open "Islamic windows" [12].

The main condition for the effectiveness of this model is the establishment of Islamic financial infrastructure in the country. We have mentioned above that the dualistic model is considered to be effective when compared to the traditional and monistic model, as is clear from the experience of countries that have introduced it today. The introduction of the dualistic model will create competitive environment for Islamic finance and the activities of competing financial institutions, encourage competition between them, and lead to the emergence of new products.



Figure 3. Roadmap for the development of Islamic finance in Kazakhstan [6]

The picture above shows us a roadmap for the development of Islamic finance in neighboring Kazakhstan, according to which the government has taken important steps to achieve the popularity of Islamic finance and raise it to a new level.

In our opinion, the dualistic model is also suitable for the introduction of Islamic finance in Uzbekistan. This model will create a legal framework and a competitive environment for the activities of traditional and Islamic financial institutions, which will allow customers to choose, meet their religious needs,

increase the country's prestige in the world community, the formation of a new market for foreign investors. .

Islamic finance, unlike traditional finance, relies on real assets, the development of which has a number of positive aspects. It contributes to the improvement of the economy and the country's financial market, as well as owning following positives:

- focus on real assets and real business;
- diversification of the financial system;
- employment of religious as well as low-income segments of the population in financial services;
- financing of priority programs of economic development;
- establishing economic relations with business entities that do not apply to financial institutions due to their beliefs and involve them in socio-financial processes;
- Ensuring the stability of the national exchange rate through the modernization of the financial market and effective assistance in meeting the needs of the banking system.

There are a number of topical issues in the legislation of our country on the introduction of Islamic finance, in particular, Islamic banking, some of which are:

1) The Civil Code establishes the principle of repayment on loans (Article 744) and bank deposits (Article 759), or the introduction of interest on loans and deposits, but in accordance with Islamic requirements, to pay interest on loans and loans or collection is prohibited because it is usury[13];

2) The Law on Banks and Banking Activities prohibits banks from engaging in commercial activities (Article 7) [14], but allows Islamic banks to engage in commercial activities;

3) Lack of tax neutrality in interest-free instruments, in other words, non-application of preferences for interest-bearing instruments;

4) Mega regulators that provide and control the liquidity of Islamic banks are not mentioned, but this issue is carried out by the Central Bank in traditional banks, which, if necessary, provide loans through refinancing rates;

5) In the issuance of securities in traditional banks, in particular government securities, their payment is made as a percentage, but in Islamic banks and finance, securities are issued on the basis of shares in circulation.

At the same time, the regulation of Islamic financial institutions and the protection of the rights of depositors, the protection of the interests of consumers - becomes a kind of systemic mechanism in such institutions, which are expected to be part of the national financial system.

Based on the above, it would be expedient to work in the following areas in the introduction of Islamic finance:

1) Improving the activities of government agencies, as well as organizations regulating the financial system;

2) Adaptation of the activities of organizations providing financial services to the requirements of the legislation related to the introduction of Islamic finance;



3) Carrying out comprehensive work on the formation of a new standard among users of modern (Islamic) financial services;

4) Creating equal conditions and facilities for the activities of Islamic financial institutions and traditional financial institutions.

### **Conclusions and suggestions**

There has been a positive trend in Islamic finance in recent years. In 2017, the share of Islamic financial assets amounted to 2.4 trillion dollars. It is estimated that by 2024, the Islamic financial market will reach \$ 3.4 trillion[15].

It is possible to expand the national financial market through the development of Islamic finance in our country. Although the introduction of Islamic finance has its own peculiarities, the growing demand for it at the international level has led to the emergence of some pressing issues in our country.

In particular:

- Lack of sufficient legal basis for the practical application of Islamic finance, in particular, the existence of fines and penalties in the current civil legislation, the calculation of interest in banking legislation and other concepts specific to the traditional financial system in Islamic finance;
- Inconsistencies in the application of accounting and financial control standards;
- Differences in tax legislation in the recognition of certain financial products, for example, murabaha as a financial practice;
- the risk of non-compliance of the conducted operations with the rules of Sharia, the absence of specialized organizations such as the Sharia Supervisory Board;
- Issues such as Islamic finance, the shortage of specialists in the field of jurisprudence.

In order to raise and improve the activities of financial service providers (banks, insurance companies, securities markets, investment companies, etc.) to a new level, it is expedient to carry out the following work:

1. While the implementation of this process has yielded positive results in the experience of most countries, it has proven to be effective in terms of making some minor changes to existing legislation. These include, for example, the legal framework for Islamic finance in countries such as Tajikistan, Malaysia and Saudi Arabia.

2. Creation of Islamic financial infrastructure (Islamic capital market, takoful, other financial instruments). In particular, the insufficient availability of this infrastructure does not ensure the successful operation of the system, which in turn has a negative impact on the efficiency and stability of the system.

3. It is necessary to establish the state organization responsible for the development and regulation of Islamic finance and its functions in terms of the management of Islamic finance and banking.

4. It is necessary to encourage educational institutions and scientific activities that train the necessary personnel in the field of Islamic finance. It is not only about qualified professionals, but also about Sharia professionals who ensure that the institution's activities meet Sharia requirements and have a unique reputation,

otherwise there are risks such as the operation of a financial institution operating on the basis of religion being recognized as contrary to Sharia law.

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