

THE ROLE OF ISLAMIC FINANCE IN BANKING OPERATIONS

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Abstract

Being one of the fastest growing industries in the world Islamic banking system attracts entrepreneurs with its fairness and no interest rate. Spreading not only in Muslim countries, but in Europe and the USA, it finances production projects that are safe for society as permitted by Sharia. In the article advantages and disadvantages of Islamic and traditional banking system, SWOT analyses were illustrated. The specific feature of the article is that it gives clear picture of financial situation of Central Asian countries, as well as, the Republic of Uzbekistan. The basic principles of Islamic banking are identified, on the basis of which the criteria for distinguishing between Islamic and traditional investment banking products are substantiated. Substantiated recommendations for the introduction of Islamic investment banking products in our banking practice on the basis of: – development of hybrid investment products; – modifications of variants of organizational structures of Islamic banks. Directions for improving the legislative environment for the introduction of investment products of Islamic banking into our banking practice are proposed based on a phased approach to the implementation of its principles and taking into account the factors that determine the volume and sequence of passing through these stages.

Keywords: Commercial banks, Islamic financing, banking services, bank loans, Islamic windows

INTRODUCTION

Today, the Islamic banking system is recognized around the world as an alternative to the rapidly evolving traditional banking system and in the short term, it has become an integrated mechanism that can fully compete with conventional type of commercial banks. Unlike commercial banks, Islamic banks have attracted entrepreneurs and business people through a profit-loss system. This system, with its fairness and low level of financial crisis, attracted not only Muslims but also members of other religions. Today, Islamic finance, Islamic banking, Islamic insurance (takaful), Islamic stock exchange is fully formed and functioning as a



system. Today, the Islamic banking system remains one of the fastest growing industries in the world and includes innovative financing mechanisms. The issue of implementing the Islamic banking system is one of the issues that have been waiting for many years to be resolved by domestic entrepreneurs. In recent years, the total assets of Islamic financial institutions have reached \$ 2.5 trillion, growing by 15-20 percent a year. The main direction of economic reforms in the financial and credit system of Uzbekistan is to address the issues related to the wider introduction of market practices, increasing financial stability, reducing the share of the state in capital, liberalization of financial and foreign exchange markets, restructuring of production.

The paper structures as follows: Section II provides the literature review, which also includes development of Islamic banking services in the world and, namely in Central Asian countries, as well as, in the Republic of Uzbekistan, while Section III presents Methodology used in the article. Finally Section IV concludes the research paper

LITERATURE REVIEW

Some of the problems associated with the establishment of Islamic windows in commercial banks and the conversion of commercial banks to Islamic banking have been studied to some extent in the scientific works by world economist scholars as Abu Hamid al- Ghazali, Sayyid Manazir Gilani, Muhammad Omar Chapra, Yusuf Qarzavi, Taqi Osmani, Alexander Walters, Nichita M., Kagitsi M., Vulpoi M., Lone A, Al-Shehri S, Muhammad Tariq Majeed, Abida Zanib, Ahmad. W, Juan Sole, Houssain K, Hassani Mohammad, Noor Ahmed Memon, Iqbal Z., Mirakhor A, Bidaulet Erlan¹ and others. In Uzbekistan Sheikh Muhammad Sadiq Muhammad Yusuf, one of the leading scholars of the country, provided information on Islamic banking services in his works “Market and related issues” (Бозор ва унга боғлиқ масалалар), “Loan and related issues” (Қарз ва унга боғлиқ масалалар)¹.

Islamic banking is a system of banking or banking activities that implements banking services in practice in accordance with the principles of Sharia (Islamic rules). The term "Islamic economy" was first used in the book "Islamic Economics" by the Indian Muslim scholar Sayyid Manazir Gilani, published in Urdu in 1947. According to Saudi economist scholar Muhammad Omar Chapra, Islamic

¹ Sheikh Muhammad Sadiq Muhammad Yusuf, “Market and related issues” (Бозор ва унга боғлиқ масалалар), publishing house “Khilol, 2019, Sheikh Muhammad Sadiq Muhammad Yusuf, “Market and related issues” (Бозор ва унга боғлиқ масалалар), publishing house “Khilol, 2019



economics is a network of knowledge that helps to achieve human well-being through the distribution of unique resources in accordance with Islamic teachings.² The Islamic banking system is defined as an organization that operates in accordance with Sharia (Islamic law) in banking and business operations, and Sharia (Islamic law) requires that these operations be legal. That is, it finances production projects that are safe for society as permitted by Sharia and prohibits the payment or receipt of interest on any transactions³. After studying the opinions of the above scholars, we conclude that an Islamic bank is a commercial organization that serves customers based on Sharia principles.

Today, two-thirds of Islamic finance is concentrated in Islamic banks⁴. Standards-economic relations of Islamic banking services are regulated on the basis of Islamic Sharia. These come in the following sequence: the Qur'an, the Hadith, the Ijma and the Qiyas. The basic principles of Islamic finance are followings:

- ✓ Any appearance of ribo (interest) is prohibited. It simply means to multiply money without any effort by lending it.
- ✓ G`orar means insufficient awareness of information. In this case, the seller and the buyer must have equal information about the product. The main purpose of forbidding it by the Shari'ah this is to prevent one party from gaining an unfair advantage over the other. G`orar isn't worth anything extra at all, but it does make a profit in return for losing or damaging someone.
- ✓ Maysir appears as economic uncertainty and unjustified quarterly risk. For example, gambling- is the accidental acquisition of wealth without any effort in exchange for harming someone else.

Islamic banking services give customers the following advantages:

1. By giving a particular person the right to amass wealth and increase economic well-being, Islamic economics sets the boundaries of halal (permitted) and haram (forbidden or illegal) ways in carrying out such economic activity. Islam broadly prohibits all activities that are economically or socially harmful. For example, engaging in gambling activities or growing drugs, engaging in drug trafficking, and other examples.
2. Recognizing the right of a person to own legally acquired property, Islam orders a person to spend his property wisely and to save it, not to waste it, and forbids it to be wasted.
3. While allowing one to keep excess wealth, Islam distributes a portion of the

² Baidaulet Yerlan. Basics of the ethical Islamic finance // 2014 – Almaty

³ Bashir, A., Hassan, M. (2004), "Determinants of Islamic Banking Profitability", ERF Paper, 10th Conference.

⁴ Citibank annual report 2018, Citi Research, Reuters, SNL Research



excess income for the benefit of society through the zakat system to the poor, the needy part of the population.

4. It regulates the accumulation and use of wealth inherent in human nature. This system does not allow the wealth of the whole society to accumulate in the hands of a few people and be managed only by them. Inheritance and its distribution are also regulated on the basis of established criteria.

In general, the economic system envisaged by Islam aims at social justice, which prevents an individual enterprise or entrepreneur from harming not only the collective but also the individual himself.

The main banking services, which are strictly defined by international standards and used by most Islamic banks, can be divided into three groups:

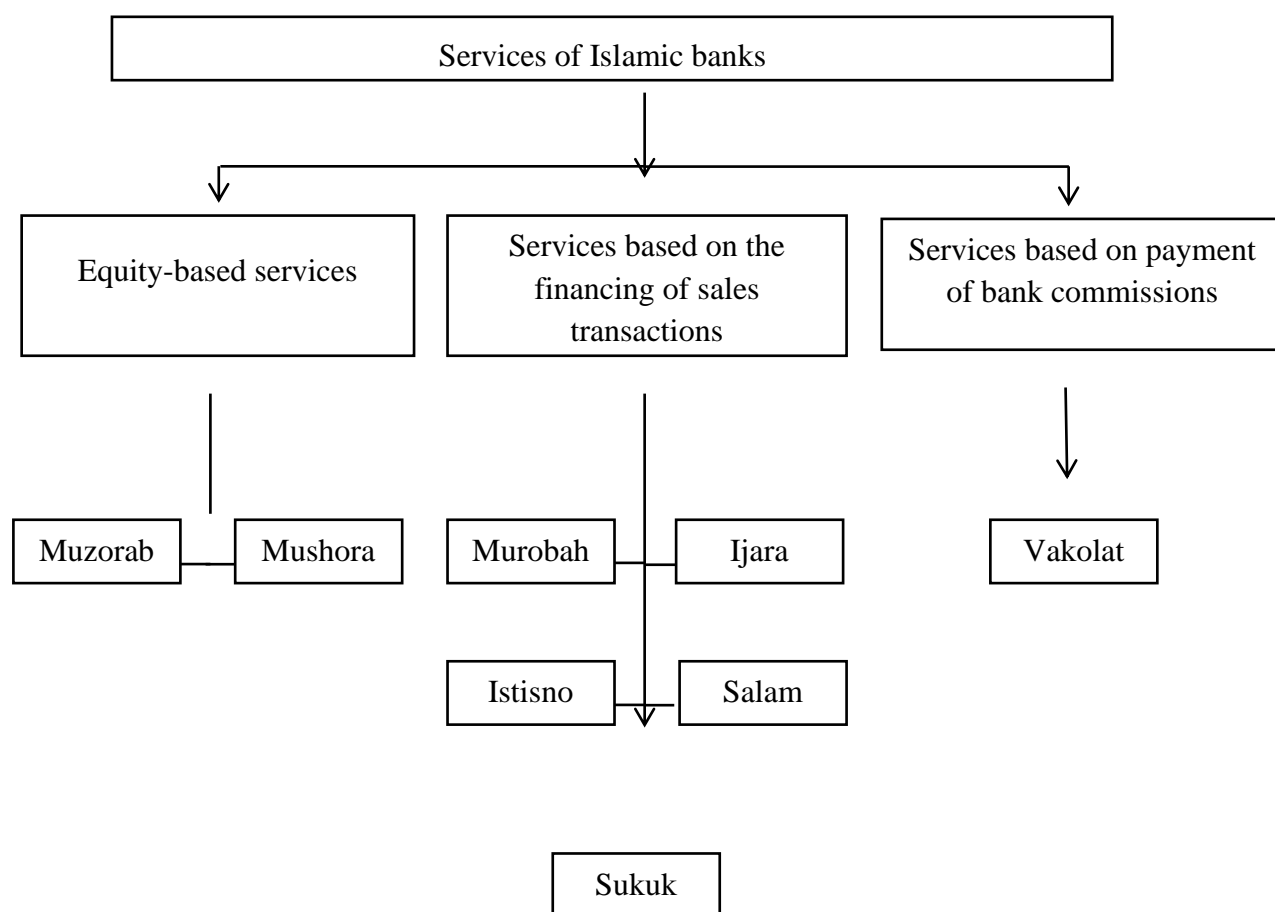


Figure 1. Types of Islamic banking services.⁵

⁵ E.A.Baydaulet, X. Hasanov "Fundamentals of Islamic Finance" Uzbekistan 2019



In the Islamic economy, money is treated as a medium of exchange. The main differences between money and product are:

(a) Money itself has no value. It cannot be used directly to meet human needs. It can only be used to purchase certain products or services. The product can be used directly.

(b) the product may be of a different quality, and as a result, product purchase agreements are made on a particular product, while money is a measure of value and a means of exchange and has no other quality. It is precisely because of these differences that Islamic law has a different approach to money than to products, which is particularly evident in the following two examples: First, (having the same value) money is not considered a commodity like other products. Its use is limited by its main function, that is, it is only a means of exchange and a measure of value. Second, if money is to be exchanged for money (e.g., shredded) or borrowed, the payment must be the same on both sides, i.e., as a result of this practice, one party may not have more money than the other.

The need for Islamic banking services is reflected in the following:

(a) Islamic bank has the ability from people, which most of the population is Muslim, to raise more funds, i.e. to accumulate deposits. Especially, this factor can attract the free money of the population in our country and invest in the production, which can be equally beneficial for the entrepreneur, the bank and the customer. It also prevents cash from being left in the hands of the population and ensures its circulation through the bank serving to reduction of inflation in its turn.

(b) Insufficient possibility of allocation of microloans through commercial banks does not provide an increase in the level of microcredit, high interest rates on services of microcredit organizations and pawnshops in most cases leads to a deterioration in the financial condition of consumers. is a set of data on high interest rates for the provision of services to microcredit organizations and pawnshops, ensuring an increase in the level of microloans. Unlike interest-bearing loans, the distribution of profits or losses by an Islamic bank creates ample opportunities for customers.

(c) The distribution of profits and losses between the partners provides additional opportunities for entrepreneurs and small and medium-sized businesses. It also plays an important role in the socio-economic development of a society.

After the official accession of the Republic of Uzbekistan to the Islamic Development Bank in September 2003, Islamic financing of projects of state strategic importance began in 2004. This year, Islamic services in the form of



"Ijara " (rent) and "Murobaha" have been used to implement projects in the health and energy sectors.

In 2019, the first Islamic insurance company "O`zaro " (Mutual) in the country began its activities. An e-Murabaha (financial product based on the Murabaha trade agreement) platform, one of the first not only in Uzbekistan but also in the CIS, has been developed. IsBF (Islamic Business and Finance), the first Islamic finance company (mainly consulting services in this field), was established, and the Islamic Finance Telegram page and website were launched to raise public awareness of Islamic finance. Leasing companies such as Taiba Leasing and Al-Mulk Capital continue to offer rental products based on Islamic principles to small and medium-sized businesses. A UN study shows that Uzbekistan has a low level of access to bank loans. Significant work has also been done in the field of education. A number of trainings on Islamic finance have been held in Uzbekistan, and books on Islamic finance have been published in Uzbek. These include Malaysian Professor Sudin Harun's book "Islamic Finance and Banking: Philosophy, Principles and Practice", Kazakh economist Erlan Baidaulet' s "Fundamentals of Islamic Finance" and Russia's Rinat Bekkin's "Islamic Economic Model and Time" (translated by Botirkhoja Juraev).

According to a survey conducted by the United Nations Development Program in early 2020 on the analysis of Islamic financial products in Uzbekistan, the main reasons for non-use of bank loans, first of all, are religious beliefs, high interest rates and the complexity of lending. If Islamic financial institutions are established in the country, the majority of respondents in the above survey noted that they can use the services of these institutions. Even traditional banks have expressed their views on the establishment of Islamic financial institutions in Uzbekistan, the emergence of fair and transparent competition in the financial sector, which will lead to an increase and diversification of investment flows into the country.

The SWOT analysis of the organization of Islamic banking services in commercial banks of Uzbekistan is analyzed, which examines the strengths and weaknesses, opportunities and risks associated with the establishment of Islamic services.

The process of launching Islamic banking services in Central Asia from Kazakhstan, Kyrgyzstan and Tajikistan has been successfully completed and positive trends are observed. Islamic finance is growing rapidly in Europe, and many European economists see the use of Islamic banking services as a lucrative opportunity to start a new business. The first attempt at Islamic banking in the Western world took place in Luxembourg in 1978, and an international holding



institution of the Islamic banking system was established. That same year, Al-Baraka was founded in the United Kingdom¹¹. In 1983, the International Islamic Bank was established in Denmark.

METHODS

In this article, to have up to date results and information, secondary data has been implemented. That's why in this article, methods as observation, abstractlogical thinking, SWOD analyses and comparison of secondary data have also been used as one of the main methods

CONCLUSION

Indeed, the active movement of free money in the economy, the use of funds to finance targeted investment projects will prevent the factors leading to the economic crisis, such as deterioration of macroeconomic indicators, including the growth of money supply due to declining money supply and, as a result, rising inflation.

There are a number of problems in commercial banks today that can be positively addressed through the establishment of Islamic banking services. The problems in the banking system are:

- Implementation of the transformation process in the activities of banks and the introduction of new types of banking services;
 - Overcoming the problems associated with improving the quality and diversification of the loan portfolio;
 - Improving the quality of services provided by banks and consumer protection;
 - Particular attention should be paid to ensuring customer awareness by providing reliable information about the services provided on the official websites, social networks and other sources of information on the terms of use of banking services.
- Also, problems such as the low investment potential of banks; lack of confidence in the banking system; high interest rates can be positively addressed through the introduction of Islamic banking services.

As a result of research in the field of development of Islamic banking services in commercial banks, we have managed to formulate the following conclusions.

It is necessary to amend the current legislation, i.e. the Law on Banks and Banking, the Law on the Central Bank, the Tax Code, the Civil Code and a number of other under the law documents. Based on the experience of Central Asian countries, it is necessary to develop a separate law on the establishment and development of a separate Islamic banking and financial system.



Attracting and using available funds at the disposal of the population and businesses through the introduction of Islamic banking services in commercial banks will increase bank income and develop the economy.

By introducing Islamic finance, commercial banks can attract more customers by supporting business entities by sharing risk in business activities. It is necessary to finance producers on the basis of Mudaraba and Musharaka methods of Islamic finance. It is advisable to use the Murobaha and Mushoraka methods from the Islamic financing models. The use of Islamic financing methods significantly attracts customers (entrepreneurs). There are two main reasons for this:

If the business fails, the loss will be divided between the bank and the client.

Due to the fact that the majority of the population of Uzbekistan is muslim, the entrepreneurs, who need the credit but cannot afford it according to their belief (interest rate is ban according to Islam) will have an opportunity to use the credit. The establishment of Islamic banking services will increase the level of diversification in the financial market and increase competition. Islamic Bank is a new banking system that uses digital technologies to provide banking services. This will help reduce costs, provide remote customer service, and make international money transfers. And commercial banks will help increase the popularity of financial services, expand the access of banks to the regions and ensure the provision of the same type of services in all settlements.

By establishing an Islamic window under commercial banks, it is possible to actively attract foreign investment into the economy of our country.

The comprehensive introduction of Islamic banking services under commercial banks in Uzbekistan will provide the country with the following opportunities:

1. Increasing and diversifying foreign investment;
2. Creating an environment of fair and transparent competition in the banking sector and the ability to diversify the assets of the banking system;
3. Ensuring maximum participation of free funds at the disposal of the population and business in the development of the economy;
4. Development and diversification of the capital market in the country;
5. Create many new jobs;
6. Increasing the activity of the population in the financial market by increasing financial literacy;
7. Coordination and modernization of infrastructure in the country through the development of the Islamic financial services industry;
8. Establishment of new financial institutions;



9. Contribute to the implementation of the state program to combat poverty;
10. Creating a training program in a new direction.

Uzbekistan can become a CIS leader in Islamic finance. As a result of this work, Uzbekistan has the opportunity to become a leader in the field of Islamic finance among the CIS countries. In conclusion, the Islamic financial services sector will be an important factor, foundation and prospects for the bright future of Uzbekistan, which will increase the interest of foreign investors in the country, which reflects the deep roots of Islam in its culture, and the government, will take full advantage of this opportunity.

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