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Islamic finance: Introduction

Oybek Axmatdjonov[1], Abdulhafiz Abdullayev[2],

Qo'qon universiteti Iqtisodiyot va Turizm kafedrasi o'qtuvchisi[1]

Qo'qon universiteti Iqtisodiyot yo'nalishi 2-bosqich talabasi[2,]

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ABSTRACT

The recurring financial crises with the Global financial crisis as a latest example have placed the financial markets operating on the basis of interest rate, normally referred as conventional financial markets, under close scrutiny. While some have looked at ways and means to fix the instability inherent in the conventional interest-based system, others have searched for alternative financial systems. In this respect, the Islamic financial system seems to offer a promising avenue for future financial resiliency and stability. However, to date, this view has been largely circulated within professional circles and only recently it has become a topic of academic inquiries.

This special issue of Pacific-Basin Finance Journal brings together a collection of academic papers that were presented at the 15th Malaysian Finance Association Annual Conference, held in Kuala Lumpur, Malaysia on June 3–4, 2013 plus two papers that have passed a normal reviewing process of the journal. These papers address various themes and aspects of Islamic finance. These include among others comparative behavior of Islamic Stock Index and Conventional Stock Index, Islamic mutual funds, Islamic bank performance, Islamic capital markets with emphasis on Sukuk, and Islamic accounting.

The increasing demand for Shari'ah-compliant stocks as an investment asset by especially Muslims is well reflected by development of screening procedures for listing a stock as a Shari'ah-compliant stock and constructions of Islamic stock market indices by index providers. While these have provided information and guidelines for financial investments that are consistent with Islamic laws, the return and risk performance of Islamic stocks especially during market downturns remain to be explored. In this special issue, three papers offer empirical evidence on the comparative performance of Islamic Stock Indices and Conventional Stock Indices. While they differ in terms of indices, sample periods, and methodologies, they arrive at a roughly similar conclusion that the Shari'ah-compliant stocks tend to perform relatively better during periods of financial uncertainties and crises.

In the paper "Performance of global Islamic versus conventional share indices: International evidence," Ho et al. compare the comparative performance of Islamic and conventional indices using Jensen alpha, Sharp ratio and Treynor index for the period 2000–2011, which covers the Dotcom crisis and the 2007–2008 Global finance crisis. Twelve major conventional indices and their corresponding Islamic indices are examined. While the comparative performance of Islamic and conventional indices is found inconclusive during the non-crisis periods, they document superior performance of the Islamic indices during the crisis periods. In a similar vein, applying a stochastic dominance approach to nine Islamic Dow Jones indices and their conventional counterparts, Al-Khazali et al. suggest the better performance of the Islamic indices during the recent global economic meltdown. Finally, "Matching perception with reality: Performance of Islamic equity investments" by Ashraf and Mohammad adopts a logistic smooth transition (LSTAR) model to assess the performance of 12 Islamic indices and 12 conventional indices during "bull" and "bear" market conditions. Again, the findings point to the better performance of the Islamic indices during market downturns. From these analyses, investing in a Shari'ah-compliant stock can better shield investors from the risks associated with market declines

Over the years, in parallel with the developments of Islamic market indices, Islamic mutual funds have been fast expanding in number and size to widen investment opportunities in Shari'ah-compliant stocks. Still, the performance of the Islamic mutual funds remains an issue largely unexplored. In an article "Heads we win, tails you lose: Is there equity in Islamic equity funds?", Kamil et al. examine the performance of 63 Islamic mutual funds currently operating in Malaysia using monthly data from September 2001 to June 2012. With few exceptions, they note that the risk-adjusted performance of Islamic equity funds does not exceed that of the market benchmarks. Further, even for the funds that outperform the market benchmarks, their superior performance is mostly due to luck than to skill of fund managers. While stressing that the analysis is not for the purpose of evaluating Islamic fund managers, they do question the equitability of Islamic mutual funds in levying fixed charges to unit holders. They further propose exploring alternative remuneration structures of the funds, hinting specifically to the use of a profit-sharing mechanism.

It cannot be denied that the establishment and operations of Islamic banks form a central feature of Islamic finance. A view generally viewed by Muslim economists as well as professionals is that Islamic banks should add stability to the financial system and should be more resilient to adverse shocks, principally on the basis that they are linked directly to the real sector and are absent from interest rate elements and speculation. The recent observed fragility of the conventional banks as well as their contributions to financial upheavals has raised an inquiry as to whether the Islamic banking business model can be a viable alternative. While several studies evaluating the performance of Islamic banks have started to emerge, the body of evidence is still limited. In this special issue, there are four papers that attempt to address some of the issues related to Islamic banks.

Romzie et al., in their paper entitled "Efficiency of Islamic banks during the financial crisis: an analysis of Middle Eastern and Asian countries", measure the overall efficiency, pure technical efficiency, scale efficiency of 79 Islamic banks operating in 12 Middle Eastern countries and 7 Asian countries. In addition, they also identify determinants of efficiency variations across these banks. An interesting finding that emerges from their analysis is the presence of scale inefficiency of the Islamic banks especially in the Middle East. Moreover, their scale inefficiency stems mostly from the fact that most banks have been operating over at the region of decreasing return to scale. Further analysis reveals that profitability and capitalization are two major determinants of the Islamic bank efficiency. Evidence is also documented for the reduced overall efficiency of larger bank size for the Middle Eastern countries, conforming to the noted finding that most of the banks are operating at the region of decreasing return to scale. This means that a policy initiative to increase the size of Islamic banks through for example mergers and acquisitions on the argument that larger Islamic banks can compete better against the well-established conventional banks is likely to be unjustifiable on the efficiency ground.

The recurrences of financial and banking crises have also placed the issue of capital adequacy at the center of discussions among economists and policy makers. Karim et al. deal with this issue by looking at the implications of capital adequacy on lending and deposit performance of both conventional and Islamic banks in their paper "Capital adequacy and lending and deposit behavior of conventional and Islamic banks." They focus on 14 OIC countries with a dual-banking system, where Islamic banks compete and operate side by side with conventional banks. They find the capital adequacy ratio to be significant in explaining deposit and loan growth of both Islamic and conventional banks. However, they also note that the assets and liabilities of low capitalized Islamic banks tend to suffer from the increase in the capitalization requirements. Hence, contrary to the view that the minimum capital adequacy requirement is irrelevant for Islamic banks due to their operations based on the profit-andloss sharing principle, capital requirements are still needed for the Islamic banks for safety net. Still, the imposition of higher capital requirements may not be amenable to the operations of low capitalized Islamic banks.

Farook et al. in their paper "Islamic bank incentives and discretionary loan loss provisions" examine the loan loss provisioning behavior of Islamic banks using 177 Islamic bank/year observations and 1785 conventional bank/year observations from 14 countries. In line with the more conservative credit criteria and lower risk investments of Islamic banks, the Islamic banks tend to have lower loan loss provisions than the conventional banks do. The results from their analysis further indicate the use of loan loss provisions to manage earnings by both Islamic and conventional banks. However, there is no clear cut evidence on the relation between profit distribution management and loan loss provisions of Islamic banks. More Islamic finance: An overview 3 specifically, the documented negative relations between profit distribution management and loan loss provisions in the baseline analysis do not extend to especially the case when the Islamic banks manage their profit distributions downwards and asset returns are higher. Moreover, their relation turns positive when the sample is restricted to only Islamic banks. Based on these findings, they indicate the need for Islamic banks to be subject to more thorough supervisions and to have improved disclosure of investment accounts

Apart from the issues of efficiency, capital requirements, loan loss provisions, supervisions and information disclosure, the success of Islamic banks to serve as an alternative banking model hinges crucially on the success of profit-loss sharing (PLS) contracts. While the PLS contracts are boasted to be a distinguishing feature of the Islamic banks, they have met with failure. Abdul Rahman et al. make an insightful assessment of this failure through the lenses of the New Institutional Economics. They argue that, as long as the Islamic banks are financial intermediaries, there is no room for the PLS contracts to grow. Being a risk-sharing instrument, the PLS contracts expose Islamic banks to business risk. This means a need for Islamic banks' involvement in the PLS-financed projects. However, being financial intermediaries, the Islamic banks have no part in the management of projects financed by the PLS contracts. According to them, PLS contracts and financial intermediaries are viewed to be incompatible duo and, for the PLS contracts to succeed, the Islamic banks must function as entrepreneurs.

Azmat et al. shift the focus to Islamic bond (Sukuk) markets, which have seen rapid growth but faced the Shari'ah-compliant risk as manifested by AAOIFI's announcement in February 2008 regarding the illicit Shari'ah practices of the Islamic bonds. The paper: “the Shari'ah compliance challenge in Islamic bond markets” provides a theoretical analysis of the Shari'ah-compliant risk of the Islamic bonds by focussing on the interactions between the players involved, namely, Shari'ah advisors, regulators, Shari'ah conscious ethical investors and issuing firms. They argue that non-compliance of Islamic bonds to the Shari'ah principles is an inherent risk stemming from high costs of being Shari'ah compliant. In the market for Fatwa, the ability of firms to shop for Shari'ah advisors, the ability of Shari'ah advisors to neutralize non-Shari'ah compliance, competition among Shari'ah advisors, and high Shari'ah fees induce non-compliance in the issuance of Sukuk markets. The analysis hints on the importance of Shari'ah conscious investors as well as mechanisms to minimize moral hazards in the Islamic bond markets.

In another article, Azmat et al. evaluate the determinants of the issuer's choice of Islamic bond type using a sample of 456 Malaysian corporate bond issues over the period 2002–2010. They consider firm-specific variables, Islamic instrument-specific characteristics as well as specific events especially the February 2008 AAOIFI announcement as potential determinants and arrive at the following conclusions. While Sukuk represents a share in tangible assets, services or usufruct, it is not viewed as such by the issuers. Moreover, there seems to be no differences between Secured-against-Real Asset (SARA) bonds or Ijarah Sukuk and conventional secured bonds. The AAOIFI announcement in 2008 is found to increase the issuer's aversion and dislike of Islamic joint venture (IJV) bonds. These main findings and others have important implications for the development of the Sukuk markets.

The final paper in this issue by Najeeb et al. brings in the accounting perspective in the Shari'ah auditing practices by arguing for the need of a profession of Shari'ah auditing. According to them, the present Islamic accounting and auditing qualifications are insufficient for producing holistic Shari'ah accountants or auditors.

Looking forward, the question is what direction should future research take? A number of papers in this issue and elsewhere point to problems and challenges facing the present configuration of Islamic finance. Currently, there are two dominant views among researchers and practitioners on the future trajectory of Islamic finance. One view suggests that the Islamic finance industry has embarked on path-dependent trajectory that will eventually converge with conventional finance and become an asset class within the latter. The result would mean the sacrifice of some of the most important features of the Ideal Islamic finance including close link between real and financial sectors, financial inclusion, relative stability and development of full-spectrum financial instrument including short-term liquidity and longtem instruments that could serve the economy's need for financial mobilization. Moreover, through its close link with conventional system, it will develop the capacity to transmit shocks and vulnerabilities to a system one of whose chief characteristics is resilience and stability. In the end, Islamic finance would converge fully to conventional finance and would at best become a new asset class in the latter system with the exception that the pricing mechanism would be non-interest in appearance.

Empirical research is needed in these areas. For example, does Islamic finance in its present form promote financial inclusion? Is Islamic finance as practiced today in a closer link with the real sector than conventional finance? Why is Islamic finance unable to develop long-term and credible instruments that are liquid and can facilitate effective hedging? While there are papers that point to micro stability, there is very little research on macrostability. There is need for research in macroeconomic policy that could suggest practical steps to strengthen the role of Islamic finance as a policy tool. There is urgent need for Shari'ah research. All the transaction modes available are bilateral real sector means in their origin. They do not have the capability of handling multilateral, multicounterparty financing. As a result, complex, non-transparent, multilayered financing is structured that makes financing of large projects expensive as they involve substantial Shari'ah, legal and administrative costs. Shari'ah research is needed that would propose new forms of multilateral, multi-counterparty, Shari'ah-compliant contracts that would match the efficiency of conventional syndication.

Another view of the evolution of Islamic finance argues that this industry is still very young compared with its centuries-old counterpart in the conventional system. The former, this view claims, operates under severe constraints that make it difficult for Islamic finance to develop along a trajectory converging to its Ideal. First of these constraint is that Islamic finance operates in a playing field that is not level. There are administrative, legal and policy biases in favor of interest rate based debt financing. Second, there is a lack of appropriate long-term hedging and liquidity mechanisms compared with the conventional system's treasury instruments. Third, macroeconomic policies in Muslim countries operate on the basis of interest rate debt financing that strengthens the conventional system. In effect, governments in Muslim countries define exogenously the conditions under which Islamic finance is to compete with conventional finance without leveling the playing field. Fourth is the lack of an efficient Shari'ah model that can handle large multilateral and multi-counterparty financing that can structure financing quickly and at reasonable costs. Fifth, there is the legal problem of incompatibility of Shri'ah transactions with the common and civil law that impose risks on Islamic contracts. On this issue, the second view maintains that there is enough commonality between the Shari'ah law of contracts and the dominant legal frameworks to allow development of new contractual forms that would be applicable in all jurisdictions. These and other questions are in need of research that would propose solutions to allow development of a more Islamic finance friendly competitive environment.

Conclusion

Finally, it is commonly acknowledged that in its present form, Islamic fiancé is organized on the basis of risk transfer, as is the conventional system. Recently an alternative view has found some traction. This view argues that risk sharing is the salient feature of Islamic finance and that the industry and Muslim governments "must" take step to move away from the present form toward risk sharing. This view was stated strongly in the Kuala Lumpur declaration issued by a group of prominent Shari'ah scholars and Muslim economists at the end of the Second Strategic Roundtable Discussions organized by the International Shari'ah Research Academy (ISRA), the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank and Durham University on 20th September 2012. Also in December of the same year, Malaysian Parliament passed new legislation governing the operations of the banking system that acknowledged risk sharing as the chief characteristic of Islamic finance. This legislation has taken the careful first step toward implementation of risk sharing in Malaysia's Islamic finance sector. Theoretical and empirical research is needed to investigate the implications of this paradigm shift. Questions that arise include, what would the shift mean for regulation and supervision of the financial system? The present infrastructure of regulation and supervision is geared toward risk transfer. What institutional arrangements (in terms of rules of behavior) are required to operationalize the shift? Will Islamic banking have to undergo a radical change as suggested by one of the papers in this volume? What would the private sector asset portfolio look like should the shift become operational? What implications would such a paradigm shift have for economic and financial policies? What would the paradigm shift mean to economic development and growth? It is known that the more risk avert the investors, the more relevant risk sharing becomes. Will the new paradigm mean greater or less emphasis on financial inclusion? These and a host of other issues require substantial research effort.

In short, the future of research in various dimensions of the theory and empirics of Islamic finance promises to provide a fertile and challenging field of creative inquiry.

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