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The Importance of Basic Financial Instruments Used in Islamic Banking

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Abstract. The article focuses mainly on the importance of basic financial instruments used in Islamic banking, the classification of Islamic financial instruments, and the definition of the instruments of mudoraba, murobaha, mushoraka.

Keywords. Islamic banks, islamic financial instruments, transactional contracts, intermediary contracts, mudoraba, mushoraka, murobaha.

It is known that Islamic banks offer a number of financial instruments that are unique in terms of content and structure and are backed by real assets. «The characteristics of Islamic financial instruments are based on the following principles:

- ✓ not applying interest;
- ✓ creating added value;
- ✓ provision of real assets;
- ✓ including moral and spiritual aspects;
- ✓ profit and loss sharing through equity participation;
- ✓ ensuring that each party has equal access to information»[1].

Islamic economic literature provides different classifications of Islamic financial instruments according to certain characteristics.

Foreign scholars[2] present the classification of contracts concluded by Grace and Iqbal Islamic banks. They divide such agreements into transactional agreements related to the implementation of operations and intermediary agreements in which the bank participates as a financial intermediary. «***Transactional contracts*** are related to production in the real sector and include trade, exchange and financing of economic activity» [3]. **Intermediary contracts** ensure the efficiency and transparency of execution of transactional agreements. A combination of transactional and intermediary contracts provides a set of financial instruments with different objectives, durations and risk levels for the successful operation of Islamic banking.

The classification of Islamic financial instruments according to transactional and intermediary contracts is presented in Figure 1.

[1] Hasanov H., Fundamentals of Islamic finance, "Uzbekistan" NMIU 2019.
[2] Grace W. and Iqbal Z. Regulating Islamic Financial Institutions: The Nature of the Regulated. World Bank Policy Research Working Paper 3227, 2004.
[3] Baidaulet E.A. Fundamentals of Ethical (Islamic) Finance: Textbook – Pavlodar, 2014.

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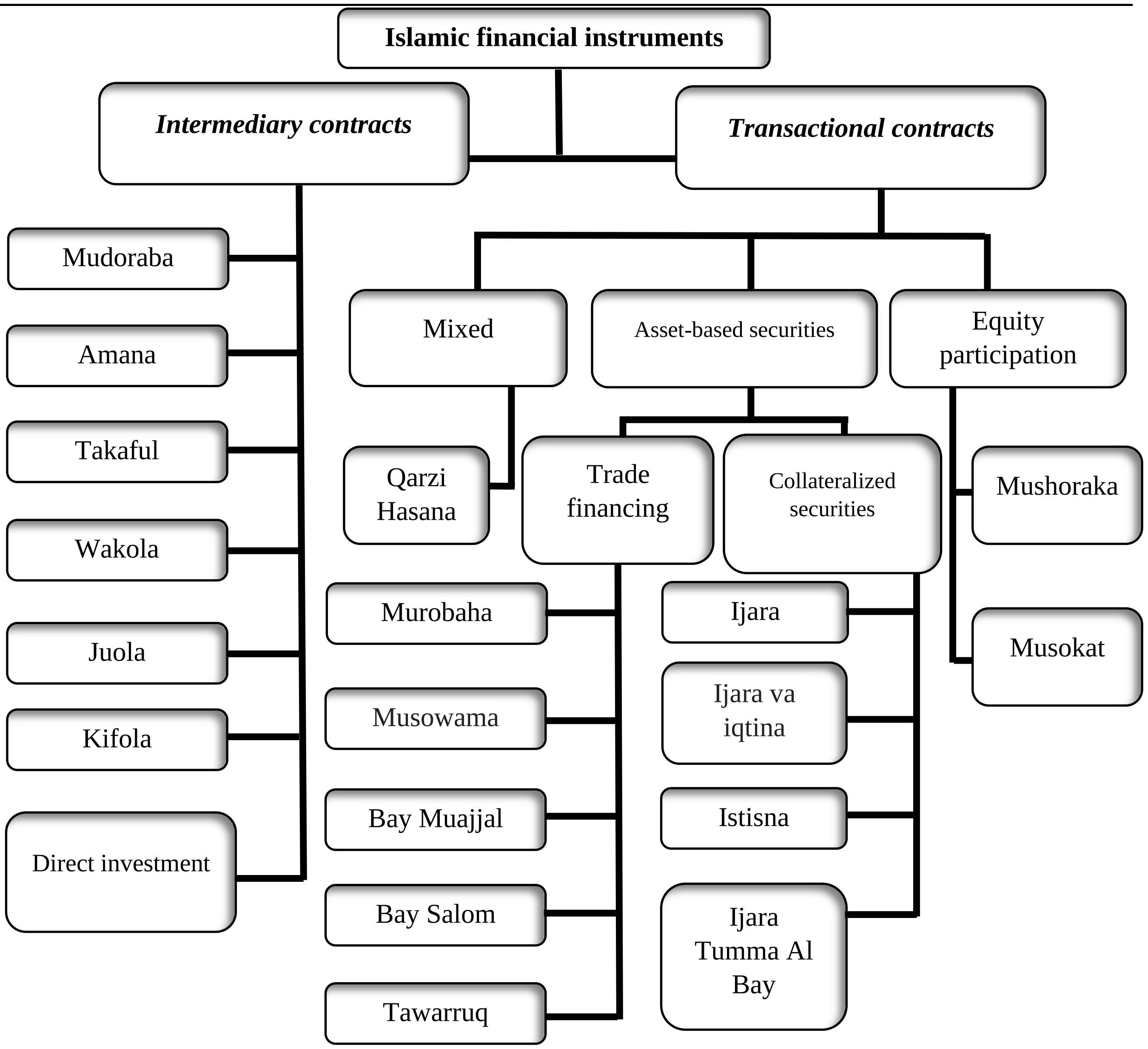

Figure 1. Financial instruments used by Islamic banks[4]

Russian expert on Islamic finance R.I. Beckin [5]divides Islamic financing instruments into two groups:

1) methods based on the mechanism of profit and loss distribution or investment methods of financing (Mudoraba, Mushoraka);

2) methods based on debt financing (Murobaha, Salam, Istisno and Ijara).

Said Al-Muharrami [6]distinguishes three main categories of financing tools used by Islamic banks: 1) sales-based tools (Murobaha, Bay Salam, Bay Inah, Tawarruq, Istisno); 2) tools based on rent (Ijara, Ijara Muntahia Bi Tamlik) 3) tools based on partnership (Mudoraba, Mushoraka, Diminishing Mushoraka).

M. Kabir Hasan and others divide financial instruments in Islamic finance into four large groups according to the principle of formation of financial products: contracts based on exchange; service-based contracts; shareholding (partnership) agreements and support agreements.

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[4]Grace W. and Iqbal Z. Regulating Islamic Financial Institutions: The Nature of the Regulated. World Bank Policy Research Working Paper 3227, 2004, with additions.

[5] Bekkin R.I. Islamic economic model and modernity. Publishing house of Marjani, Moscow 2009, 93-p.

[6]Saeed Al-Muharrami. Islamic Banking: Basic Guidelines for Researchers. European Journal of Social Sciences, Vol. 45 No. 3 December, 2014.

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1. Contracts based on exchange: Murobaha, Istisno, Salam or Bay Salam, Bay Dayn, Bay Inah, Tawriq (securitization), Sarf (currency trading), Tawarruq (reverse Murobaha).

2. Contracts based on services: Ijara (lease), Ijara Muntahia Bi Tamlik (financial lease), Ijara Tumma Al Bay (lease and later purchase), Ijara Mausufa Fi Dimma (forward lease), Ujro (payments), Juola (commission or award).

3. Contracts based on equity participation: Mudoraba (reliable financing), Mushoraka (joint venture, partnership), Mushoraka mutanaqisa (Decreasing Mushoraka).

4. Supporting contracts: Hawala (transfer of debt), Rahn (pledge/security), Muqosa, Kafola (guarantee), Waqola (agency), Wadia (custody) and unilateral supporting contracts.

The classification of Islamic financial instruments according to the principle of formation of financial products is illustrated in Figure 2.

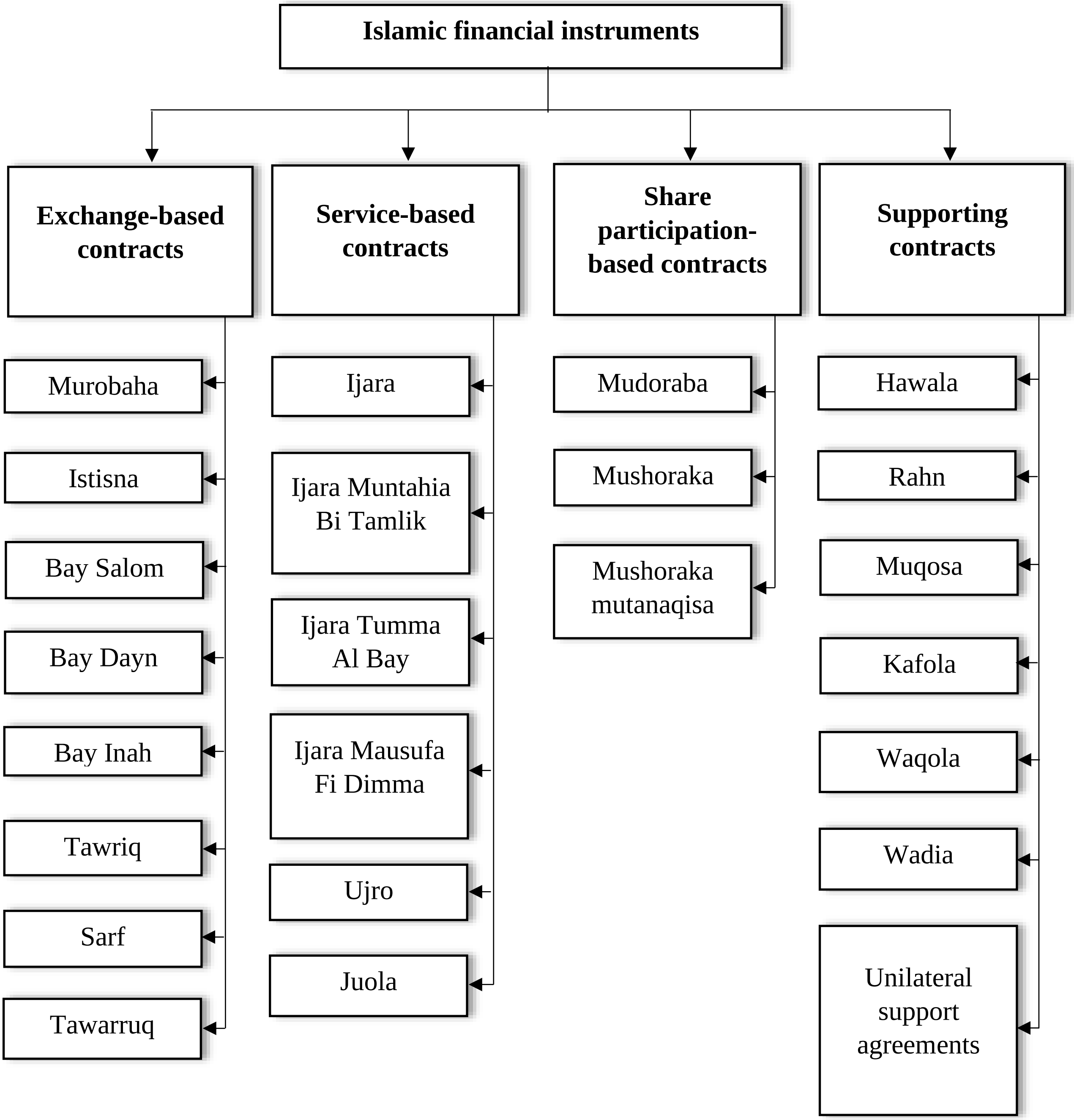

Figure 2. Classification of financial instruments according to the principle of formation of financial products[7]

[7] Based on the classification cited by M. Kabir Hassan et al.

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Thus, in our opinion, the classification made by Kabir Hasan et al is more complete than that of other scholars and covers a wide range of Islamic financial instruments. We will take a closer look at the following two main categories of financial instruments that are widely used in Islamic banking listed in this classification:

1) financing based on equity participation;
2) exchange-based financing.

Equity financing, also known as equity or partnership financing, is based on the profit and loss sharing (PLS) mechanism, rather than interest, and includes the following financial instruments:

- ✓ Mudoraba (trust/limited/investment partnership);
- ✓ Mushoraka (joint venture, joint venture);
- ✓ Musharaka mutanakisa (decreasing partnership).

Mudoraba is a partnership between two or more parties in the field of business or trade, in which one party called *Rabbul Mol* (capital owner/investor) provides funds, and the other party called *Mudarib (entrepreneur/fund manager) participates in the management of the business with his knowledge and experience.* is enough.

In this type of contract, the bank (Rabbul Mol) entrusts its funds to an entrepreneur (Mudarib) who has the necessary conditions and opportunities for their effective use, as well as sufficient experience and reputation. If the project is successfully implemented, the profit from the invested funds will be distributed between the parties in a pre-agreed ratio according to the agreement made at the time of signing the contract. Losses, if they occur, are covered only by the Bank, and the entrepreneur, in this case, does not receive a fee for his activities and actions. A simple structure of Mudoraba contract is shown in Figure 3.

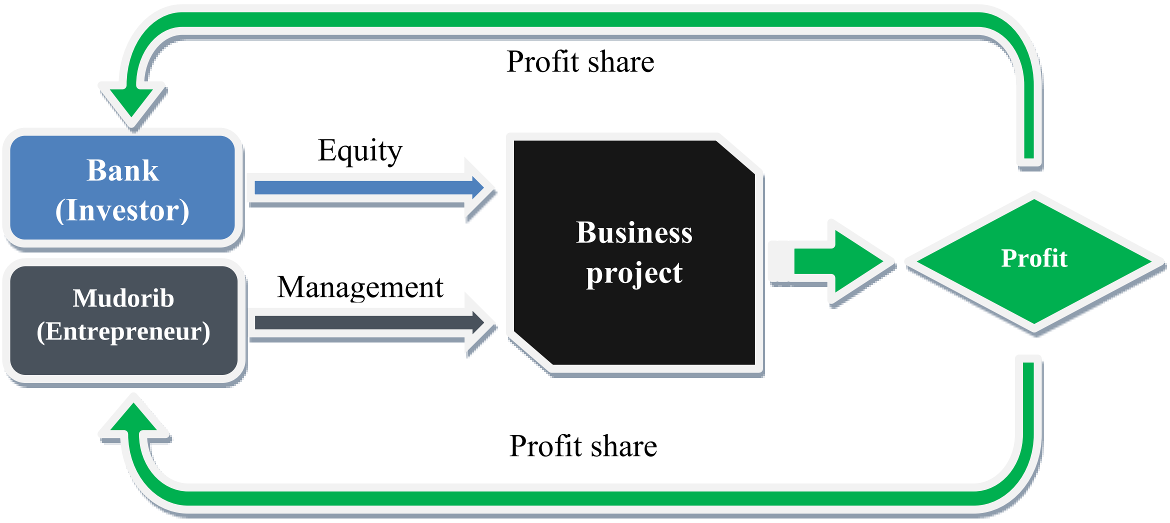

Figure 3. A simple structure of a Mudaraba transaction[8]

The bank does not have the right to demand collateral against the provision of funds. In addition, the bank does not interfere in the day-to-day management of the project. At the same time, the entrepreneur has no right to direct the funds received from the bank to the financing of other projects not provided for in the contract without the bank's permission, he cannot attract other sources of financing or use his own funds . An entrepreneur's expenses are limited by his time and labor. However, if the negligence and mismanagement of the entrepreneur is proven, he will be responsible for financial losses.

Mudoraba is usually used to finance short and medium term investment projects. Mudoraba contracts are similar to secured financing in the traditional financial system. Such contracts can be concluded not only

[8]M. Kabir Hassan, Rasem N. Kayed and Umar A. Oseni. Introduction to Islamic Banking & Finance: Principles and Practice. Pearson Education Limited, 2013.

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between the bank and the entrepreneur, but also between the bank and its depositors. The depositor participates as a bank, and the Bank as an entrepreneur.

It is worth noting that the risks of Mudoraba contracts are very high, as no collateral is required for the funds provided by the bank, and therefore such contracts are not very widespread.

Mushoraka is a partnership of a bank and one or more entrepreneurs in a joint project, using the same rights and obligations, combining their capital or labor on the basis of mutual trust and participating in the profits and losses of the joint venture or project.

This type of partnership involves the signing of a partnership agreement between the bank and other partners, in which the parties to the agreement jointly finance a joint project. At the same time, according to the contract, a part of the profit received by the bank from the business activity is paid to the partners participating in the project in a predetermined ratio, or the profit is distributed among the partners in proportion to their participation in the financing of the project. Losses are covered by partners in proportion to their capital contributions to the project. The simple structure of a musharakah transaction is illustrated in the figure below.

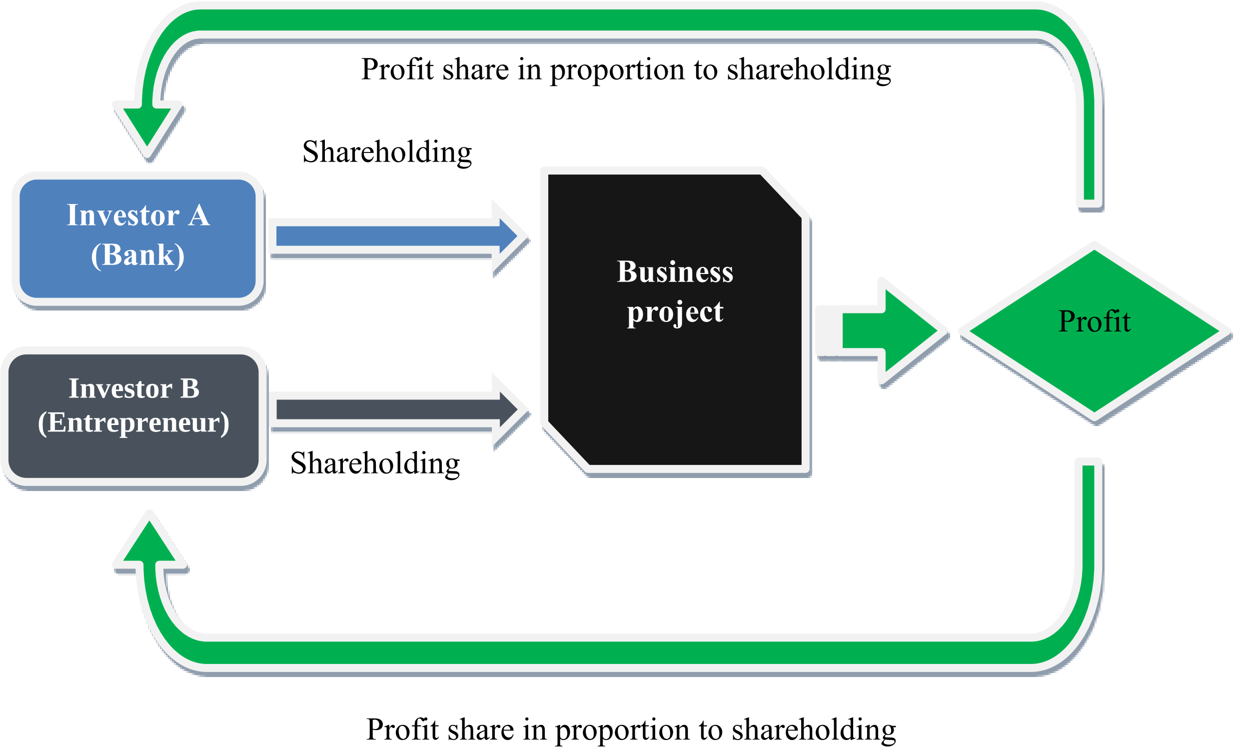

Figure 4. A simple structure of a Musharaka transaction[9]

The project can be financed by more than two partners, in which the project management is carried out by all participants or by one of them. The advantage of this tool is that it allows for the creation of flexible contracts, in which the specific characteristics of the partnership, shares in the distribution of profits and forms of management are agreed in advance by the partners.

Musharakan can be said to be the implementation of portfolio investments in investment projects by the bank. This type of partnership is perfect because the interested parties have voluntarily entered into a contractual agreement for joint investment and sharing of profits and risks.

Musharaka contracts can be used to supplement the company's working capital or for joint investment activities. This type of contract is often used to finance long-term investment projects.

A declining Mushoraka. This method can be used to buy assets such as houses and cars. For example, in a diminishing Mushoraka contract, the bank and the customer are partners.

[9]M. Kabir Hassan, Rasem N. Kayed and Umar A. Oseni. Introduction to Islamic Banking & Finance: Principles and Practice. Pearson Education Limited, 2013.

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According to this contract, the customer must provide a part of the value of the house, for example 20%, in order to buy a house in partnership with the bank. In this case, the bank owns the remaining 80% of the house, which the customer pays in installments over a period of time. Since the customer lives in the house, he pays rent (rent) to the bank at a certain percentage for the share owned by the bank.

Over time , until the client buys the house outright, his share increases, while the bank's share decreases, so does the rent.

Exchange-based financing, also called debt-based or trade-based financing, includes instruments such as Murabaha, Musawama, Salam and Istisno, which are widely used in Islamic banking.

Murobaha (reliable sale). Murabaha is the simplest Islamic banking instrument and is a widely used product. Islam forbids the charging of fixed interest on money, but allows a fixed profit on the sale of goods. Therefore, Islamic banks use Murobaha, a sales-based transaction for financing.

Murobaha is a sales contract in which profit is obtained by selling on a cost-plus basis. This is an agreement in which the bank buys a certain item at the customer's request, adds a pre-agreed profit to it and sells it to the customer at an increased price.

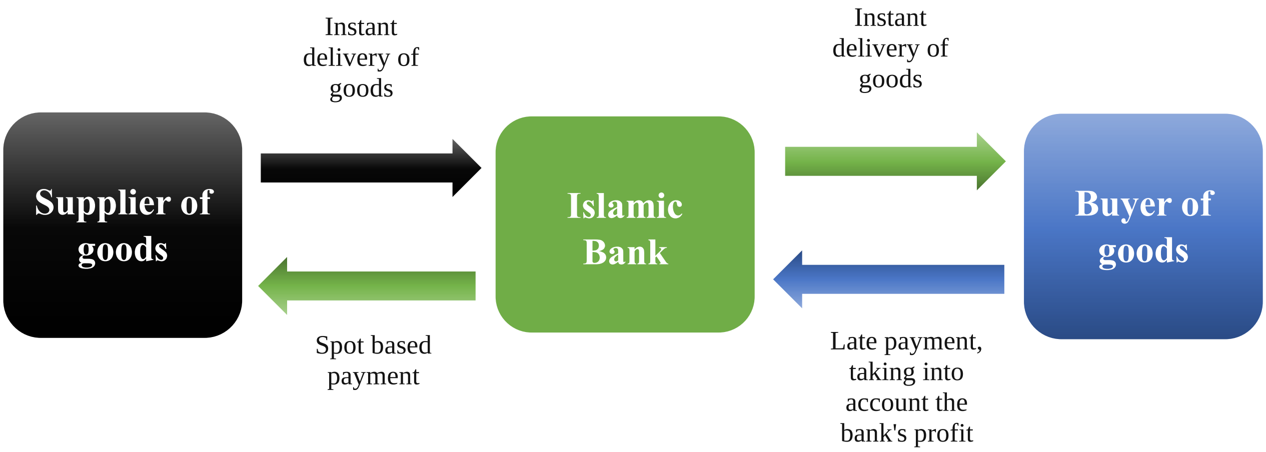

Figure 5. The structure of a simple transaction of Murobaha[10]

Murobaha is also called fiduciary selling, because the distinguishing feature of murobaha from ordinary sales is that the seller discloses the costs to the buyer and a certain profit is added; the buyer trusts the seller to purchase the desired item and to disclose to the customer the quality or characteristics of the item and the actual cost as well as the added price. If there are any storage, transportation or other costs incurred by the seller in delivering the item to the buyer, these costs will be added. The fixed fee can be a one-time fee or a percentage of the price of the item. Delivery of goods is carried out immediately. The customer can pay on spot basis or on deferred basis. Sales are mostly made on deferred payment, so credit is extended and this is used as a method of financing when the customer requires funds to purchase goods. Murobaha is used for trade deals, working capital financing and fixed asset financing.

In fact, in the analytical report on the results of the research on the implementation and use of Islamic finance products in Uzbekistan[11], 81% of banks answered that the introduction of the Islamic financial system in Uzbekistan increases the possibility of attracting their free funds to types of deposits or partnership agreements due to the great interest of the population in Islamic finance (Table 1).

At the same time, 15% of banks said against it, that is, they said that there is little demand for Islamic finance, and 4% of banks said that there is no demand at all. When asked which Islamic finance products are more effective in supporting entrepreneurship in our country, 81% of banks answered that Mushoraka and Mudoraba, because these products are based on partnership, 66% of banks answered that Murobaha and Ijara

[10]M. Kabir Hassan, Rasem N. Kayed and Omar A. Oseni. Introduction to Islamic Banking & Finance: Principles and Practice. Pearson Education Limited, 2013.

[11] Jakhongir Imamnazarov. Analytical report on the results of a study on the implementation and use of Islamic financial products in Uzbekistan. United Nations Development Program project "Financing sustainable development in Uzbekistan". 2020.

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products are effective, because similar types of activities exist in Uzbekistan. (i.e. in the sense that applying Murobaha and Ijara is not difficult).

Table 1
Evaluating the effectiveness of Islamic financial products[12]

Which Islamic financial products are more effective in Uzbekistan and why?	**Banks**	
	the number	percentage
Mushoraka and **Mudoraba** , because these are based on partnership	22	81.48%
Murobaha, because this contract allows you to buy goods in arrears	18	66.67%
Ijara, because this financial product is similar to a lease, and therefore it will be easy to fully implement this type of contract in our country	18	66.67%
Salam, because within this product, agriculture can be pre-financed (as a loan), which is very useful in our country, where agriculture is an important sector	11	40.74%
Istisna, because this product is similar to Salam, only it is very useful in the field of financing investment projects and construction, which are developing rapidly in our country	11	40.74%
Sukuk, because we have a very urgent issue of developing the stock market, and it is in line with the policy of our country	12	44.44%
We don’t know	0	0%
Total	27	100%

In general, Islamic banking is a Shariah-based financial intermediation system in which interest is not allowed and all transactions and transactions are based on a profit and loss sharing (PLS) mechanism that ensures fairness and equity in society.

For Islamic banks, the pre-determination of payments, the prohibition of money-making and speculative behavior, the distribution of profits and losses, the acceptance of contracts in accordance with the Sharia and their sanctity apply.

In Islamic financial intermediation, Islamic banks use a two-stage Mudoraba concept based on the distribution of profits and losses instead of the traditional debit-credit system.

Most countries have dual banking systems. In them, Islamic banks work side by side with traditional banks. Conventional banks implement Islamic financial instruments through their separate structural units (Islamic branches, separate branches and subsidiaries).

Islamic banking uses equity-based (such as Mudoraba and Mushoraka) and exchange (debt)-based financial instruments (such as Murobaha, Salam, Istisno).

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[12]Jakhongir Imamnazarov. Analytical report on the results of a study on the implementation and use of Islamic financial products in Uzbekistan. United Nations Development Program project "Financing sustainable development in Uzbekistan". 2020.

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