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Banking Activity Model in the Islamic Finance Doctrine

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ABSTRACT. The article focuses on the existing contractual forms of raising capital by an Islamic bank, i.e. on the process of banking in the doctrine of Islamic finance. The author studies the model of banking activity in the Islamic economic doctrine and identifies the instruments for its implementation. An Islamic bank (as well as a conventional bank) offers its customers similar types of banking services which can be grouped into three types of "deposit" accounts: a) current; b) savings; c) investment. Today, Islamic banking uses the following forms of fundraising (in addition to the mudarabah contract – the profit and loss sharing model): wadiah (interest-free deposit); wakala (deposit); qard al-hasan (interest-free or charitable loan), which operate on the basis of an agency relationship between the Islamic bank and its client. A separate method of financing small and medium-sized businesses (SMEs) in the concept of Islamic banking is hawala, which functions as an informal financial and settlement system based on the offset of claims and obligations between participants, and kafala, a financial contract that involves the transfer of risk and responsibility. The study of service contracts, wakalah, hawala and kafalah allowed comparing them with their analogues in conventional financial relations and concluding that an Islamic bank is an ordinary financial intermediary performing functions similar to those of a conventional bank in the financial market, but with the use of specific contractual forms consistent with Islamic law. A critical analysis of the concept of "current premium" (margin) of a financial institution in the concept of interest-free banking, which ultimately forms its profit, is carried out. The concept of creating an Islamic interbank market on the basis of "Islamic principles", i.e., with the dominant role of the profit and loss sharing model, which is a key element of Islamic economic doctrine, is critically examined. The author identifies some

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significant limitations to the possibility of effective functioning of this concept in practice – in a competitive financial market of an open market economy. The general conclusion of the study is that despite a significant number of developed and standardised organisational and legal forms and models of banking activities in the Islamic finance doctrine, there are still significant contradictions and unresolved problems with regard to key economic categories, such as, for example, the definition of "margin", the use of interbank financing instruments, and effective management of bank liquidity. Moreover, in our opinion, the resolution of some contradictions within the interest-free banking paradigm is a difficult task for Islamic lawyers, economists and financiers.
KEY WORDS: Islamic economic doctrine, Islamic finance, financing of commercial activities, Islamic banking, service contracts, wakala, hawala, kafala

Introduction

The Islamic economic doctrine is based on certain prohibitions dictated by the provisions of Islamic law, which, in turn, determines specific organisational and legal forms of financial relations and instruments for conducting/financing economic activities. Like conventional banks, an Islamic bank is a financial intermediary between those who form the supply of capital in the financial market (custodians, depositors) and those who need it – borrowers (the demand side of capital). In other words, an Islamic bank performs the same function, but in a slightly different way, using specific forms (contracts) for both placing capital and attracting it. In this article, we propose to focus on the existing contractual forms of raising capital by an Islamic bank, i.e. on the liability side of its balance sheet.

The study of the doctrine of Islamic finance is mainly carried out by economists from Muslim countries, and most often, with the aim of justifying the advantages of a religious and ethical approach to building the principles of the economic system. Many of these studies lack critical analysis and empirical substantiation, which in turn hinders the dynamic development of the concept of Islamic finance, leads to the emergence and existence of inconvenient instruments that are either ineffective or risky in the realities of modern commercial activity. Therefore, in our opinion, systematisation, comparison and critical analysis of the existing components of the Islamic economic doctrine using the methodology of scientific analysis is an urgent task.

The purpose of the study is to use the methods of classification, systematisation and generalisation to investigate the model of banking in the Islamic economic doctrine, to identify the tools for its implementation, to formulate the existing limitations to the further development of Islamic banking and to provide a critical analysis of the proposed concepts and directions of transformation of Islamic finance. Accordingly, the object of the study is the process of banking in the doctrine of Islamic finance. The subject of the study is the religious restrictions of Islamic law, which determine the specifics of the organisational and legal forms of banking.

Analysis of contractual forms of raising capital by an Islamic bank

Currently, there is a large number of scientific studies on the development of Islamic economic doctrine in the world. The main academic centres are: Islamic Economic Institute (Jeddah), Institute of Islamic Banking and Insurance (London), Islamic Finance Academy (Dubai), International Centre for Islamic Finance Education (Kuala Lumpur). In Ukraine, a certain scientific contribution to the study of this issue is made by the Centre for the Study of Islamic Finance, which was established at the Kyiv National Economic University. The Centre's researchers have recently made a number of publications: on defining the essence of the doctrine of Islamic finance[4], [5], [6], on studying the dynamics of its qualitative development, on the principles of structuring in the concept of Islamic finance[7] and on the main models of its functioning[8] , etc. This paper continues this series of publications.

An Islamic bank (as well as a conventional bank) offers similar types of banking services to its clients, which can be grouped into three types of "deposit" accounts: a) current; b) savings; c) investment[9].

Current accounts in Islamic banking function similarly to conventional current accounts and are not intended for investment. These accounts are fully guaranteed by the Islamic bank, do not bear interest and are repaid immediately upon request. The bank can use these funds at its own risk, and depositors are not entitled to a share in the profits earned by the bank[10] .

Saving accounts are also not intended for investment in theory, although the depositor "allows" the bank to use his or her funds. These accounts are fully guaranteed by the bank, although it is not obliged to pay any remuneration to the depositor. However, in practice, most Islamic banks, in

[4] Mozgovyi O. M., Subochev O. V., Yurkevych O. M. The current state of the Islamic finance industry: statistics of qualitative development. Investments: practice and experience. 2017. No. 7. p. 8-14.

[5]The essence and development of the doctrine of Islamic finance. *Ekonomika Ukrainy*, No. 1 (674) 2018, pp. 71-82.

[6] The essence and development of the doctrine of Islamic finance. *Ekonomika Ukrainy*, No. 2 (675) 2018, pp. 65-79.

[7] Structured finance as a separate element of the global financial system. *Economy and State*. 2020. No. 11. pp. 47-53.

[8] Mozgovyi O. M., Subochev O. V., Yurkevych O. M. Basic models of functioning of Islamic finance: a critical look. *Investments: practice and experience*. 2017. No. 6. pp. 20-25.

[9] Banking Services. Islamic Markets. URL: https://islamicmarkets.com/education/banking-services (accessed 13.02.2021).

[10] Sources of Funds of Islamic Banks. Islamic Markets. URL: https://islamicmarkets.com/education/sources-of-funds-of-islamic-banks (accessed 13.02.2021).

order to attract customers, either pay a monetary reward from their profits at the end of the financial year or provide certain privileges to the holders of these accounts (e.g. financial support for small projects, instalment payments for consumer or producer goods, distribution of gifts, etc.) For example, at the end of 2021, the yield on savings accounts of Emirates Islamic Bank was 0.25% per annum, and Dubai Islamic Bank – 0.14% per annum[11] .

Investment accounts are intended for investment and are specific to Islamic banks. This type is somewhat analogous to time deposits in traditional banking, but there are some differences. Theoretically, this is not a "deposit", but money transferred by the "depositor" to the bank for investment on the basis of a *mudarabah* contract, in which the bank acts as a manager (agent). Theoretically, an Islamic bank cannot determine in advance what level of return it will be able to provide to a client and even guarantee the return of funds to the client. However, in practice, Islamic banks offer fixed rates of return for these accounts, which are usually higher than for other types of deposits. For example, the yield on the investment account of Dubai Islamic Bank at the end of 2021 was 0.75% per annum[12] . Such a difference in yield (0.14% and 0.75%) is determined by the existing restrictions for this type of deposit: the minimum amount, fixed term of the deposit, etc.

Investment accounts in an Islamic bank differ in the level of authorisation by the client to use the invested funds and can be restricted (limited) – the account holder authorises the bank to invest his or her funds in the types of assets chosen by him or her – and unrestricted (unrestricted) – the objects of investment of the client's funds are determined by the bank itself.

In order to attract funds from customers to deposit accounts in the concept of interest-free banking, a number of financial instruments (contracts) were invented that are consistent with the principles of Islamic jurisprudence. At the early stages of Islamic banking development (70s of the twentieth century), it was proposed to use the Ammanah contract, but it proved to be not convenient for attracting deposits for two reasons:

- the bank was not allowed to use the depositor's funds to generate its own income (according to Islamic law);
- the bank was not obliged to return/compensate depositors in case of loss.

Thus, this type of deposit contract was replaced in Islamic banking, as it neither encouraged the financial institution to use the funds attracted efficiently nor protected depositors from numerous risks of violation of the

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[11] Dubai Islamic Bank. Official website. URL: https://www.dib.ae/global/profit-rate (accessed 13.02.2021).
[12] Dubai Islamic Bank. Official website. URL: https://www.dib.ae/global/profit-rate (accessed 13.02.2021).

Principal's interests by the Agent. Today, Islamic banking uses the following forms of fundraising (in addition to the *mudarabah* contract – the profit and loss sharing model): *wadiah* (interest-free deposit); *wakala* (deposit); *qard al-hasan* (interest-free or charitable loan), which operate on the basis of an agency relationship between an Islamic bank and its client. Let us consider them in more detail.

A wadiah agreement, or "guarantee of safe custody", in Islamic law defines the relationship of custody, trust. The agreement can be used both for the storage of property on the basis of trust (Wadiah yad amanah) and for the storage of funds (Wadiah yad Dhamanah)[13] , and in this case it is used to attract savings to deposit accounts. In Islamic banking, this agreement is used to service current accounts, as the main principle of *wadiah* is the possibility for the principal to terminate it early, i.e. withdraw funds from the deposit.

Wadiya is a non-profit banking product and, as a rule, the bank charges a fee (commission) for servicing the account, although in some cases it may pay a "gift" – a hibah – based on the results of its activities to reward its customers. Although, according to Islamic law, *hibah is* a voluntary transfer of property (or part thereof) without any material compensation, Islamic banks may use this concept to make payments to their customers in the form of a "gift", for example, on current account balances. Although such a "gift" is similar to bank interest, it is essentially a voluntary payment that is made (or not made) at the bank's sole discretion and is not guaranteed in the current account agreement[14] .

As the *wadiah* contract provides a guarantee of repayment of the full amount at the request of the depositor, the use of funds raised in this way involves significant liquidity risks.

Another type of agency agreement is the wakala, under which one party, the agent (*wakeel),* appoints another party, the principal (*muwakkel),* to perform certain actions on its behalf for a fee, usually a fixed fee. This contract is used in numerous Islamic financial products to collect and pay trade invoices and letters of credit, invest, distribute debts, guarantee, make payments (e.g., analogue of domiciliation of bills of exchange, etc.). Unlike the *wadiah agreement*, the nature of the activity, subject matter and terms of the agency agreement must be clearly defined.

The mechanism of using the *wakal* model as a deposit agreement is shown in Figure 1.

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[13] Meshkat Mahbub, Anisul Mannan Shammo (2016). "Does 'Wadi'ah' Follow Islamic Principles in Islamic Banks?" IOSR Journal of Business and Management (IOSR-JBM), Vol. 18, Issue 6 .Ver. IV, pp 39-45.

[14]Hibah Amanah. URL: TH.https://www.tabunghaji.gov.my/en/savings/services/hibah-amanah-th

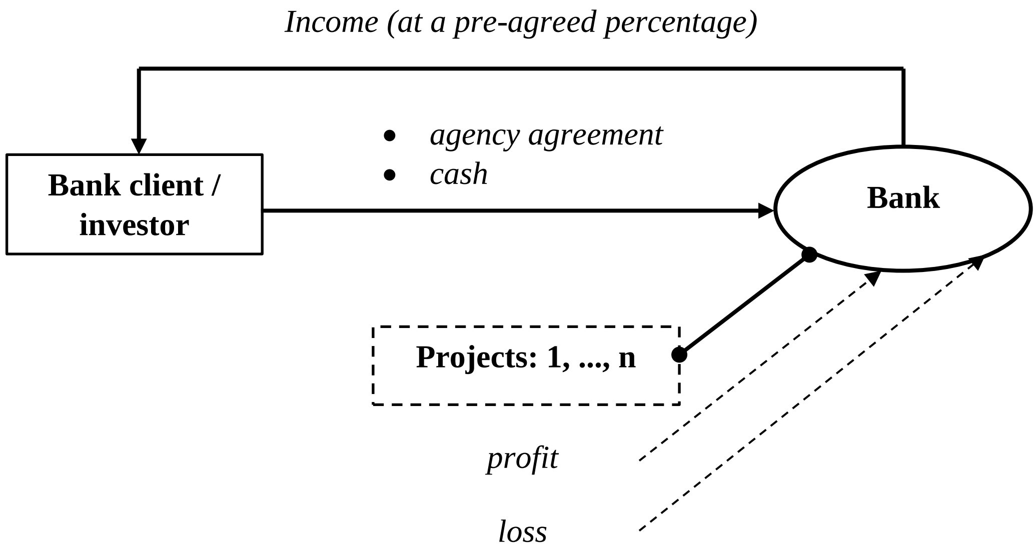

Figure 1. Deposit contract in Islamic banking

Source: compiled by the author based on data from [15]

In Islamic banking, the *wakala* contract is used to open savings and investment deposit accounts (similar to term deposits), with the bank being allowed to invest the principal's funds and distribute profits in an agreed manner as long as the required minimum balance is maintained in the client's account[16] .

In this agreement, the client of an Islamic bank (principal) deposits money and instructs the bank (agent) to carry out investment or any commercial activity not prohibited by Islamic law on his behalf for a certain fee (commission). As a rule, the bank determines the expected profit for the client from its "deposit" (which is analogous to the deposit interest rate) and agrees on this in the agreement. The actual profit is distributed according to a pre-agreed-upon ratio, and any excess over the agreed percentage is retained by the bank as an "additional incentive".

Formally, the bank, acting as an agent on behalf of the client on a commission basis, does not bear the risk of losses, this is the responsibility of the principal – its client. Taking into account the existence of a high risk of the "Agent-Principal Problem" in its extreme form (a theoretical model of the economy created to understand management situations between unequal

[15] Islamic Markets. URL: https://islamicmarkets.com/education/wakala-deposit
[16] Ibid.

actors with different degrees of information), such an approach would make the very existence of this instrument impossible. Therefore, an Islamic bank, when using a *wakala* contract to raise funds, tries to ensure a certain level of income for the client in any case. For this purpose, the so-called Reserve Funds for Income Equalisation and Investment Risk Coverage are formed (in order to achieve the target return on the investment portfolio for all active operations of the bank).

The only type of loan permitted in the concept of Islamic finance is Qard al-Hasan, an interest-free or charitable loan that is granted on a voluntary basis. The debtor is obliged to repay only the principal amount of the debt, but he has the right, at his discretion, to pay a premium (above the principal amount) as a sign of "gratitude" to the lender. At the same time, the main condition of the *qard al-hassan* contract is the absence of a "promise of such gratitude". Islamic jurists consider such a loan to be the only type that does not violate the *riba* prohibition, as it does not compensate the lender for the value of money with regard to the time factor[17] .

Funds in this form are allocated to both individuals and legal entities for the purpose of providing humanitarian assistance. Such loans are used as an attempt to alleviate poverty or stimulate the development of local (usually rural) communities. Funds for such loans are established by private institutions and raise their capital by attracting interest-free term deposits or charitable contributions.

In the context of inflation, Islamic law allows the loan amount to be measured in terms of the price of a particular consumer good (rice, wheat). Upon expiry of the *card al-hasan* loan, the borrower pays an amount of money equivalent to the amount of the selected commodity that could have been purchased at the time of the contract.

Despite the absence of commercial benefits, this type of financial relationship plays an important role in Islamic religious ethics, as it contributes to "equitable distribution of income, elimination of caste differences, reduction of unemployment and support for the development of the poor members of the Muslim community"[18] .

The Qard al-hassan loan can be seen as an analogue of microfinance for development with some elements of credit union and charity.

Another way of financing small and medium-sized businesses (SMEs) in the concept of Islamic banking is *hawala*, which is a cooperative relationship between SMEs and an Islamic financial institution.

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[17] Zainal Abidin, Ahmad; Alwi, Norhayati Mohd; Ariffin, Noraini Mohd (2011). "A case study on the implementation of Qardhul hasan concept as a financing product in Islamic banks in Malaysia". International Journal of Economics, Management, and Accounting. Issue 19, pp. 81-10.

[18] Jaenal Effendi (2013), The Role of Islamic Microfinance in Poverty Alleviation and Environmental Awareness in Pasuruan, East Java, Indonesia. A Comparative Study. Universitätsverlag Göttingen. [Access mode: https://univerlag.uni-goettingen.de/bitstream/handle/3/isbn-978-3-86395-137-5/effendi.pdf?sequence=1&.

From the very beginning, *hawala* (Arabic for "transfer") existed as an informal financial and settlement system based on the netting of claims and liabilities between participants (brokers) in the Middle East, Africa and Asia. The system was formed in the Hindustan Peninsula long before the advent of the Western banking system and the spread of Western banking in the Middle East. *Hawala,* as a financial and settlement system, is based on the transfer of funds by means of one-time messages (e-mail, fax or telephone calls) between its brokers. Material assets in the form of money (gold and silver) are moved from country to country without accompanying financial documents. Since all financial transactions are carried out by netting (clearing) or in person, state regulatory authorities are unable to track these flows[19] . Individual *hawala* networks are often built on the basis of trust, for example, among people with family ties or people from the same region.

The *hawala* financial and settlement system operates as follows:

a) the sending client contacts a broker of one of the networks and transfers money to him;

b) the broker sends a message to its partner in the country of payment destination containing only the amount, the name of the payee and a code (a set of words or numbers, such as the series and number of any banknote);

c) to receive the money, the recipient just needs to come to a local broker of the same network and give the payment code.

According to some sources, there are about 5000 *hawala* brokerage points in the world[20] . They usually operate in large bazaars in Muslim countries. Given its lack of control by state authorities, lack of transparency and chaos, the *hawala* settlement system is often accused of money laundering, terrorist financing and tax evasion.

Since the early 2000s, the Islamic Corporation for the Development of the Private Sector (ICD) has proposed using the *hawala* model as a tool for financing SMEs in the format of a cooperative with the participation of a non-bank financial institution in Muslim countries. The pioneer of this example was the association of small businesses in the field of trade – Propindo Islamic Cooperative (Indonesia)[21] .

The purpose of this cooperative is to provide its members with working capital, as these SMEs usually receive payment for goods/services provided over several months and have liquidity problems in their business.

There are three parties involved in a hawala finance model: The SME (the lender), the SME's counterparty (the buyer-debtor), and the cooperative, a

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[19] Report on Money Laundering Typologies 1999-2000, FATF-XI (February 2000). URL: https://web.archive.org/web/20011108063734/http://www.oecd.org/fatf/pdf/TY2000_en.pdf

[20] The role of Hawala and other similar service providers in money laundering and terrorist financing, FATF Report, October 2013. URL: http://www.cbr.ru/StaticHtml/File/36805/The_role.pdf.

[21] Kasri, R., & Dewi, M. K. (2011). "SMEs Financing Innovation: Application of Hawalah in Islamic Cooperative". International Journal of Excellence in Islamic Banking and Finance, 1(2), 1-15.

non-bank financial institution that performs clearing functions and finances its member SME. Once a debt is created between the SME and its counterparty, hawala occurs when the SME transfers the debt to the cooperative, which in turn finances the SME based on the value of its receivables and then collects it from the SME's counterparty. In this way, the hawala cooperative not only clears the trade, but also provides liquidity to its member, in return for a fee (Figure 2).

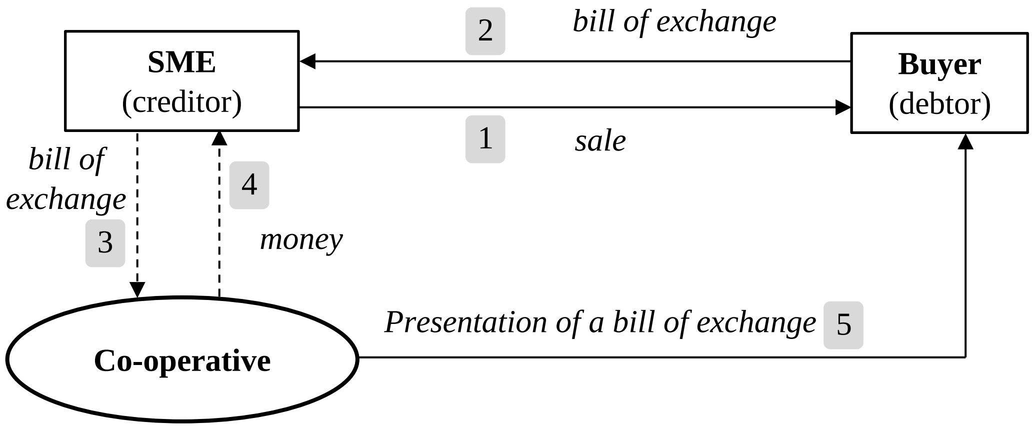

Figure 2. A *hawala* contract-based SME financing model.

Source: compiled by the author based on data from [22]

Figure 2 illustrates the financing of an SME by an Islamic non-bank institution on the basis of a *hawala* contract. After the SME delivers certain goods/services to the counterparty (1) and receives a deferred payment cheque (bill of exchange) (2), it transfers it, on the basis of a *hawala* agreement, to the Cooperative (3-4), which, in turn, provides funds and collects the debt in its favour from the SME debtor (5). A prerequisite for the legality of this transaction from the point of view of Islamic law is that the amount of income (commission) of the cooperative is linked to the "real costs of providing this service"[23].

Another common form of financial contract in Islamic banking is a kafalah, a bank guarantee. This contract, like the *hawala*, involves the transfer of risk and responsibility. *Kafalah* is a guarantee of repayment of

[22] Al Raisi, A. K. S. D.; Rodriguez, I.; Tustikbayev, M.; Omarova, N.; Abdul Rahman, A. W.; Muneeza, A. (2016), "Implication of Ḥawālah in Islamic Finance Practice", International Journal of Management and Applied Research, Vol. 3, No. 3, pp. 109-119.

[23] Al Raisi, A. K. S. D.; Rodriguez, I.; Tustikbayev, M.; Omarova, N.; Abdul Rahman, A. W.; Muneeza, A. (2016), "Implication of Ḥawālah in Islamic Finance Practice", International Journal of Management and Applied Research, Vol. 3, No. 3, pp. 109-119.

accounts payable (existing or probable). Islamic law allows creditors to demand security for debt repayment, so under a *kafalah* contract, an Islamic bank guarantees the use of assets/services to the parties involved in the transaction[24]. In some Muslim countries, such as Malaysia, the guarantor may also be a non-bank financial institution, for example, Cagamas SRP Berhad, Credit Guarantee Corporation Berhad – are not banks[25]. This contract plays an important role in international trade and finance by reducing counterparty risks. The model of using the *kafalah* contract is shown in Figure 3.

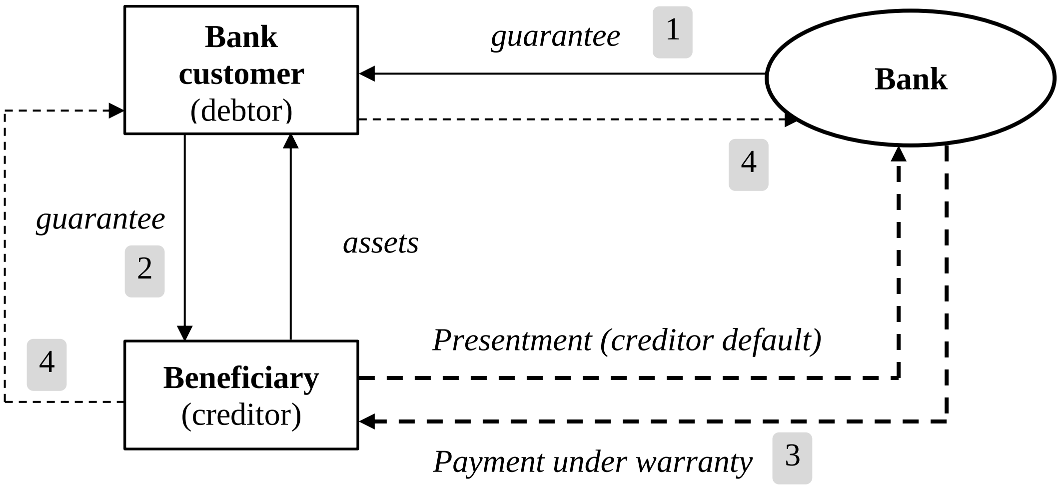

Fig. 3. The model of using the *kafalah* contract

Source: compiled by the author based on data from[26]

An Islamic bank provides a guarantee to a client in the form of issuing a registered documentary security IBG (Islamic Bank Guarantee), which specifies the beneficiary (potential creditor), the amount of the guarantee and its validity period (1). The bank's client then transfers this document to its counterparty (2), which, in the event of the client's default, will require the bank to make immediate payment on demand of the amount specified in the guarantee (3). If the default does not occur, the beneficiary returns the IBG to the bank, with subsequent repayment to the Islamic bank (4).

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[24] Osenim, U. (2013), "Towards restructuring the legal framework for payment system in international Islamic trade finance", Journal Of International Trade Law & Policy, Vol. 12, No. 2, pp. 108-129.

[25] Badri, M. B. and Bouhreaou, D. S. (2014), "Charging fee on letter of guarantee-is it permissible? Fatwa in Islamic Finance, Issue 2, pp. 2-3.

[26] Badri, M. B. and Bouhreaou, D. S. (2014), "Charging fee on letter of guarantee-is it permissible? Fatwa in Islamic Finance, Issue 2, pp. 2-3.

A certain analogue of the *kafalah* contract in traditional finance is the aval bank bill of exchange, but unlike a bill of exchange, an IBG registered documentary security cannot be traded on the secondary market and has no market price.

In Islamic jurisprudence, the practice of using a *kafalah* contract remains a subject of debate. The majority of Islamic legal schools (Hanafi, Shafi'i, Maliki, Hambalite)[27], do not allow the bank to charge a fee for a guarantee contract, which they consider to be a benevolent contract. In addition, if the bank's client fails to fulfil its obligations to its counterparty – in case of default – the relationship between the guarantor (bank) and the guaranteed party (client) turns into a debtor-creditor relationship, and the bank's charging of any fee from the client in excess of the guarantee amount leads to the emergence of *riba al-nasi'a* [28],[29]. South Asian Islamic lawyers (e.g., International Islamic *Fiqh* Academy), on the contrary, allow the bank to charge a fee, appealing to the principle of *fiqh al kharaj bi daman* – "profit comes with liability"[30] .

The position of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is that the guarantee fee is allowed only when it relates to actual costs incurred by the institution, such as legal, documentary, administrative, etc. However, there is still no consensus on the exact method of calculating the actual cost of the expenses incurred. There is always a risk of manipulation of costs by a financial institution. As for the occurrence of *riba* in the event of a client's default, this does not happen in practice, as Islamic banks require the client to provide various types of collateral before issuing IBGs[31] .

Comparison of *wakala*, *hawala*, and *kafalah* service contracts

In summary, the *wakala*, *hawala* and *kafalah* contracts discussed above are the most commonly used service contracts in modern Islamic banking and transfer risk and control. In some details, they even have the same economic

[27] Syed Alwi, S. F., Ibrahim, U. and Sawari, M. F. (2014), "A Few Methods in Charging Fees for Kafalah Bank Guarantee-i Among Islamic Banks in Malaysia", ISRA International Journal of Islamic Finance, Vol. 6, No. 1, pp. 51-66.

[28] *Riba al-nasi'ah* occurs when payment is deferred in time and may mean a premium to the principal amount of the debt paid in exchange for a deferred payment. This type of riba is present in a loan agreement and means any surcharge to the principal amount of the debt received by the lender as a condition of lending funds for a certain period of time (*author's remark*).

[29] The essence and analysis of the content of key prohibitions in the Islamic economic doctrine. International Journal "Financial Space". 2021. No.4 (44). https://fp.cibs.ubs.edu.ua/index.php/fp/article/view/839/1031.

[30] Shahimi, S., Ismail, A. G. and Ahmad, S. (2006), "A Panel Data Analysis of Fee Income Activities in Islamic Banks", Journal of King Abdulaziz Islamic Economics, Vol. 19, No. 2, pp. 23-35.

[31] Kureshi, H. and Hayat, M. (2014), Contracts and Deals in Islamic Finance: A User's Guide to Cash Flows, Balance Sheets, and Capital Structures, Singapore: John Wiley & Sons.

content, for example, *hawala* and *kafalah* – guaranteeing the performance of the agreement, but have different functional applications. A generalised definition of these service contracts is shown in Table 1.

Table 1

COMPARISON OF *WAKALA*, *HAWALA* AND *KAFALAH* SERVICE CONTRACTS

Wakala	***Havala***	***Kafalah***
definition		
Refers to a contract in which one party (*muwakkil*) authorises the other party, as its agent (*wakil*), to perform a specific task in matters that may be delegated voluntarily or for a fee.	Means "change" or "transfer" and usually refers to the transfer of a debt from the original debtor to a legal entity.	The Arabic word for "responsibility" or "surety" refers to the action of someone undertaking to fulfil obligations and bear responsibility with another person.
Official definition according to the **Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI)**		
Shariah Standard (AAOIFI) No. 23: "delegation of one party to another, to act on its behalf in respect of what may be the subject of the delegation".	Shariah Standard (AAOIFI) No. 7: defines Hawala as the transfer of a debt obligation from the holder to the payer.	Shariah Standard (AAOIFI) No. 5: Guarantees to secure obligations and protect the amount of debts from uncollectibility or default.
The source of legality in Islamic law		
It is mentioned in the Hadith of the Qur'an and in Ijmah (Surah Al-Kahf, verse 19).	It is mentioned in the Qur'anic Hadith Al-Bayhaqi	It is mentioned in the Sunnah of the Prophet Muhammad (Al Bukhari, Al-Jami' Al Sahih, 3/94).

Source: compiled by the author based on [32], [33], [34], [35].

To summarise, Table 2 provides a generalised and systematic comparison of the organisational and legal forms of Islamic finance – service contracts of *wadia*, *wakala*, *qard al hasan*, *hawala*, *kafalah* – with their analogues in conventional financial relations.

[32] Bank Negara Malaysia (2015), Wakalah Concept Paper, [Online], available at: https://www.academia.edu/18131745/Wakalah_Concept_Paper_Bank_Negara_Malaysia_?auto=download

[33] AAOIFI (2010), Accounting and Auditing Organisation for Islamic Financial Institutions. Bahrain: Dar Al Maiman.

[34] Investopedia. URL: https://www.investopedia.com/terms/h/hawala.asp

[35] Bank Negara Malaysia (2015), Kafalah Concept Paper, [Online], available at: https://islamicbankers.files.wordpress.com/2013/12/22092015-cp_on_kafalah.pdf

Table 2

COMPARISON OF WAKALA, HAWALA AND KAFALAH SERVICE CONTRACTS WITH THEIR ANALOGUES IN CONVENTIONAL FINANCIAL RELATIONS

Organisational and legal form	Analogue in conventional financial relations
wadia	current account, demand deposits;
wakala	an agency agreement for collecting and paying trade invoices and letters of credit, investing, distributing debts, guaranteeing, making payments; in Islamic banking, it is used to open savings and investment deposit accounts (analogous to time deposits);
qard al-hassan	micro development finance with some elements of credit union and charity;
hawala	financial and settlement system; SME financing in the format of a cooperative;
kafala	aval bank of a simple / transfer bill

Source: developed by the author.

Differences in corporate governance in Islamic banking

Another most distinctive feature of an Islamic bank is the presence in its governance structure, in addition to the classical Board of Directors (executive body), of The Shari'ah Committee (Figure 4).

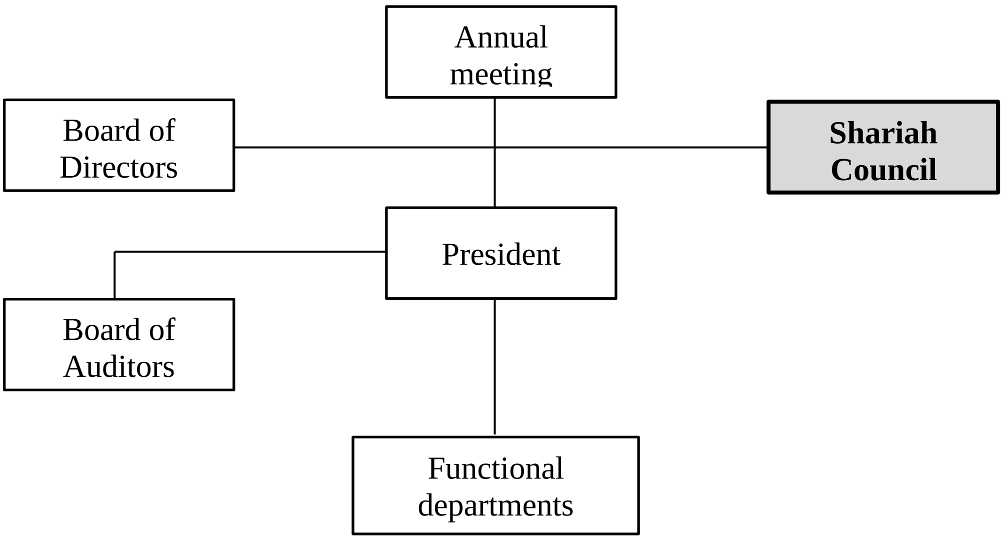

Fig. 4. Model of the governance structure of an Islamic bank

Source: developed by the author.

Since the raison d'кtre of Islamic banking as a phenomenon is the desire to comply with the requirements of Islamic law in the field of finance, the presence of a Shariah Board is a clear marker for counterparties that the bank conducts business in this way. However, not all Islamic banks have a full-fledged Shariah Board. Some may have only one advisor. Others may seek advice from many, but only when the need arises. However, most banks retain this body, which meets from time to time and issues guidance on typical transactions and contracts, and issues an annual statement confirming the commitment of the Islamic bank's management to the advice and guidance of the Shariah Board in respect of religious observance in the conduct of business.

A typical Shariah Board of an Islamic bank may have such functions and responsibilities:

- is responsible for the general supervision of compliance with Islamic law in a financial institution;
- Ensures that each transaction of a financial institution complies with the requirements of Islamic law (approves standard contracts);
- protects financial institutions from the reputational risk of non-compliance with Islamic law;
- presents to the general meeting reports on the review/audit of the application of Islamic law in the financial institution (annual declaration accompanying the bank's financial statements), discloses products/instruments that meet/do not meet the existing requirements, and in case of non-compliance, offers possible alternatives;
- researches and updates the requirements for Islamic financial products/instruments, taking into account the latest development trends in the Islamic finance industry[36] ,[37].

As can be seen from the above functions, the Shariah Council is mainly a supervisory and advisory body, but it is able to intervene and significantly influence the financial operations of an Islamic bank. In this context, it is worth mentioning the cancelled plans to place on the Irish Stock Exchange by the American bank Goldman Sachs the issue of *sukuk* – "Islamic debt securities" for a total value of USD 2 billion in 2012[38] . Abu Dhabi Islamic Bank was supposed to be an investor in these securities, but the Shariah Council of the bank recommended cancelling the deal, formally arguing that "Goldman Sachs may use the funds raised to provide interest-bearing loans"

[36] Yusuf Abdul Fattah. The Role of Shari'ah Advisory Committee (SAC) in the governance of some Islamic cooperative Societies (ICSs) in Iloren Emirate. URL: https://www.academia.edu/40691542/THE_ROLE_OF_SHARI_AH_ADVISORY_COMMITTEE_SAC_IN_THE_GOVERNANCE_OF_SOME_ISLAMIC_COOPERATIVE_SOCIETIES_ICSs_IN_ILORIN_EMIRATE.

[37] Nurhastuty W. and Shaista A. The Role Of Shariah Board In Islamic Banks: A Case Study Of Malaysia, Indonesia And Brunei Darussalam, 2nd ISRA colloquium of Bank Negara Malaysia. 2012.

[38] Goldman advisor defends $2 bln Islamic bond scheme. URL: https://www.reuters.com/article/goldman-sukuk-controversy-idCNL6E7NV08O20120102.

and that "these securities may not be traded at par on the Irish stock exchange", which is contrary to Islamic law

It remains unclear whether this decision of the bank's Shariah Council (since the issue was cancelled at the last minute) was a principled decision of Islamic jurists or just a formal reason for refusal, but the precedent was set – the deal did not go ahead.

Thus, summing up the results of the study on the peculiarities of attracting funds by a bank in the Islamic economic doctrine, it can be argued that an Islamic bank is an ordinary financial intermediary performing functions similar to those of a conventional bank in the financial market, but with the help **of specific contractual forms consistent with Islamic law**. In this regard, the question arises as to how exactly the current "margin" (margin) of a financial institution in the concept of interest-free banking is determined, which ultimately forms its profit?

Model of the Islamic interbank market

Current practice shows that Islamic banks are guided either by the current interest rate of local conventional banks in the domestic market or by the LIBOR (London interbank offered rate) in foreign economic transactions. This practice is often criticised by the most conservative Muslim jurists and economists on the grounds that in Islamic economic doctrine, interest rate-based profits should be as prohibited as interest itself. However, this is not possible today, as the total assets of Islamic financial institutions are still too small and represent a very small share of the global financial market: 1% (+/- 0.5%), and the share of Islamic finance in the financial systems of many Muslim countries does not exceed 25%[39] .

Therefore, Islamic financial institutions operate in a certain environment in which they are not market makers and are forced to focus on the benchmark (in terms of return and risk) set by the conventional financial market. Moreover, despite calls to abandon this practice, it is still unclear what alternative benchmarking system for target returns and risk can be used in Islamic economic doctrine instead of the system of bank interest rates, the key of which is set by the Central Bank.

Numerous concepts regarding the introduction of different from the existing conventional indicators of determining the "margin" for Islamic financial institutions are either unviable in an open competitive market or contradictory in terms of their effective functionality. The most well-known and logically obvious, given the dominant role of the profit and loss sharing model in the doctrine of Islamic finance, is the concept proposed by

[39] World Islamic Banking Competitiveness Report 2016. URL: http://islamicfinance.in.ua/files/EY-world-islamic-banking-competitiveness-report-2016.pdf

Muhammad Usmani, an Islamic jurist and one of the founders of the largest Pakistani Islamic bank, Meezan Bank.

This Islamic jurist has published extensively on Islamic finance and chairs the Shariah Council of the influential international organisation, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), a Bahrain-based organisation that develops accounting, auditing, governance and ethical standards. It is also a permanent member of the International Islamic Academy of *Fiqh* (Islamic Law), a body of the Organisation of Islamic Cooperation. Thus, his concept of developing and implementing his own interest rate benchmark as an indicator of profitability in the financial market is the most discussed and authoritative.

The essence of this concept is to create its own interbank market based on "Islamic principles", which will determine the required rate of return for Islamic financial institutions in the form of a certain rate (Figure 5).

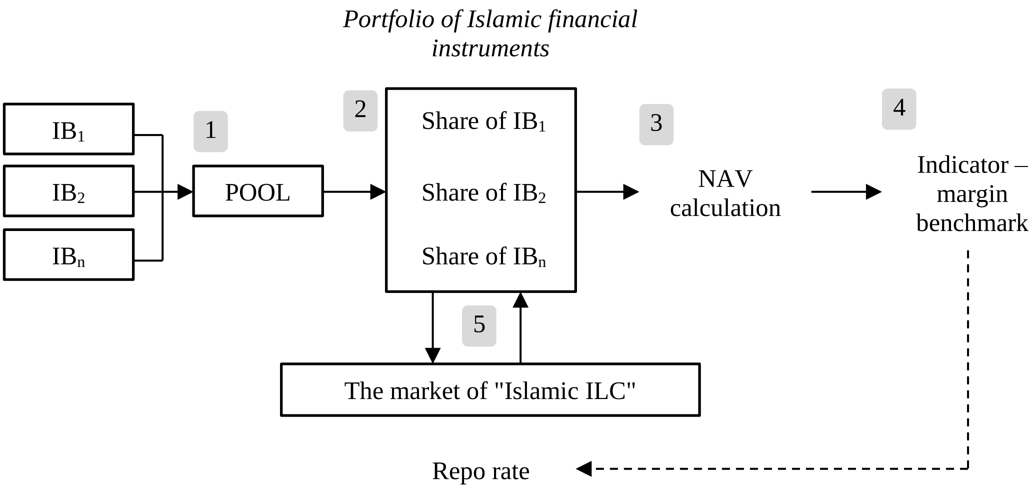

Fig. 5. Model of the Islamic interbank market (proposed by M. Usmani) based on "Islamic principles"

Source: developed by the authors.

For this purpose, it is proposed to create a certain joint pool (fund) between Islamic banks (1), which will invest in Islamic asset-backed instruments, such as, for example, *musharaka*, *ijara,* etc. (2). Since most of the assets of this pool will also have a tangible form, such as leased property or equipment, shares in companies, etc., the value of its units can be determined by the net asset value (NAV) of the assets held in the portfolio of this pool using the formula: NAV = (Assets − Liabilities) / number of shares (units) in circulation (3). In turn, the net asset value can be determined on a periodic basis, and the dynamics of their growth rate: $t_{np} = \frac{y_1 - y_0}{y_0} \times 100\%$, and will be the same indicator for the benchmark for determining the "margin" for Islamic financial institutions when using Islamic financial instruments in models based on trade, lease or partnership (4). In addition, the pool units/shares could be used for interbank financing at an overnight rate (for a period not exceeding one business day), similar to the conventional interbank loan market (ILC). To this end, those banks with excess liquidity could purchase these units/shares on a repurchase agreement (sale and repurchase obligation at a specified price) basis, at a rate equal to the "Islamic benchmark", and vice versa, when they need liquidity, they could sell them on the same terms (5).

Thus, despite a certain economic logic of the above concept of creating an interbank market based on "Islamic principles", it contains, in our opinion, some significant limitations as to the possibility of its effective functioning in practice – in a competitive financial market of an open market economy. The following comments can be made.

1. The existing conventional rate (e.g., LIBOR), which is determined by: a) the current key policy rate of the Central Bank and b) the supply and demand for debt capital in the banking market, is an indicator of the market weighted average rate of the entire financial market, which in turn affects the cost of capital for all areas of economic activity, for all economic agents, regardless of their size, ownership structure, organisational form or current rate of return of the industry in which they operate. At the same time, any proposed methodology for selecting assets to the Pool (or, accordingly, removing them from it) to obtain this indicator will be entirely artificial in nature, requiring justification not only in terms of including certain assets, but also in terms of determining their share. Obviously, market mechanisms and instruments of influence on the contracts of economic agents are more optimal from the point of view of achieving a state of general equilibrium in the entire economic system. In addition, in our opinion, even the most sophisticated methodology does not allow to "pack" the entire economy into a certain index, which is what needs to be done to justify the inclusion of certain assets with a certain share in the calculation of the "premium" (margin) in the concept of interest-free banking.

2. In the case of a private mutual fund, the selection of assets in the portfolio should be consistent with its own investment strategy, and the calculation of the net asset value of its assets at a certain date is a common procedure for assessing the effectiveness of investment decisions. Thus, the goal of a private mutual fund is to achieve an optimal risk-return ratio, in line with its investment strategy. In the case of the proposed "national pool" organised by analogy with a private mutual fund, the objective of the

methodology will be different – to obtain a certain weighted average indicator of the growth rate of the net value of assets that should reflect "all types of economic activity" (i.e., determine the state of the entire economy), even if some types of assets representing the relevant areas of activity have a relatively lower current rate of return. In our opinion, such adherence to the principle of universality (in order to calculate a weighted average for the entire market) at the expense of inefficient investments cannot be considered an optimal economic solution.

3. The portfolio of a conventional open-ended investment fund (and the proposed Pool should function on such a basis) contains assets that are public, transparent, liquid, and massive. This is what makes it possible to calculate the NAV indicator. At the same time, the most of Islamic financial instruments are not marketable – they are not liquid (not traded) and not standardised (created for a separate agreement). In the absence of a secondary market as such, in our opinion, it is impossible to effectively assess the net asset value of a portfolio.

4. A significant part of the assets of a mutual fund is the aggregate value of securities in the portfolio, calculated on the basis of the respective prices for each trading day. Depending on the dynamics of the stock market, the NAV may be highly volatile, and the growth rate and especially the growth rate may even be negative[40] . The same applies to the proposed Pool. In order for the benchmark rate for Islamic banks to be > 0 at all times, there must be a constant growth rate of the NAV of this Pool. Obviously, this condition cannot be met, since the value of the shares of the companies to be included in the Pool will be influenced not only by the results of their business activities, but also by the stock market conditions, which are determined by the dominant mood of economic agents: optimism / pessimism.

5. The established interest rate in the market is a benchmark for making investment decisions for the future, as it allows economic agents to plan the expected return taking into account the current cost of capital. At the same time, the proposed indicator should only be the actual result of the Pool's activities based on the actual growth of assets in its portfolio over the past period. In this regard, the question arises whether the interchange of these indicators, which are different in their economic essence, is correct at all.

6. The methodological problems of determining the Islamic benchmark rate, especially in terms of its application for interbank financing, may also include inconsistencies in the time line for obtaining data for calculation. For example, the net asset value of an open-ended investment fund is calculated on a daily basis, based on quotes at the close of the business day.

[40] Growth rate is the increase of any variable over a time period. The rate of increase is the increase of any value under study over a time period minus 100%. The growth rate and the rate of increase are measured as a percentage and are relative values. The growth rate is always a positive value, while the growth rate can be negative. The growth rate is equal to the growth rate minus 100%.

At the same time, the net value of real physical assets (leased property, equipment, real estate to be included in the assets of the Pool) and on the balance sheet of companies can be calculated on the basis of their financial statements, for example, quarterly, as there is no need to obtain this indicator on a daily basis. Also, in this case, the question remains: who should pay for the fair valuation of non-current assets? And not just once a year (when the company's annual financial statements are audited), but much more often.

7. The proposed model also ignores the problem of cyclical economic growth, i.e., the logic of its functioning (based on "Islamic principles") does not include measures of state monetary policy. It is well known that the Central Bank interest rate is a very powerful and effective tool for influencing aggregate output (production), unemployment, inflation, exchange rate, etc.

Conclusions

Thus, in view of all the above, such a model based on "Islamic principles", in our opinion, can only be **non-market,** which will further require its administrative regulation through constant change of assets in the portfolio, "manual" determination of their profitability or even through direct establishment by the authorised body of the appropriate value of the indicator of the current "margin" of a financial institution in the concept of interest-free banking (regardless of the value of the Net Asset Value). Undoubtedly, such a model can be viable and functional, in our opinion, only in a closed (regional) economic system with direct administrative regulation, but its effective scaling in the global financial system is questionable.

As for the analogue of the conventional interbank loan market, which is aimed at managing the liquidity of a banking institution, the concept of Islamic banking has developed a number of financial instruments similar to the money market and repurchase agreements (see, for example, Bank Negara Notes / Bank Negara Debt Certificates (BNNN), BNMN, BNIDC): Bank Negara Negotiable Notes (BNNN) / Bank Negara Monetary Notes (BNMN), Negotiable Islamic Debt Certificates (NIDC) [41], [42], classical *tawarruk murabaha,* etc.).

However, as these instruments were developed by more liberal South Asian Islamic organisations, they raise certain concerns from more conservative Arab legal scholars. First of all, the legitimacy of using repurchase agreements from the point of view of Islamic law (it is considered a hidden *riba)*. Therefore, today, the contractual form of *wakala* discussed above is mainly used in practice. In the context of using *wakala* in the

[41] Bank Negara's Official site. URL: https://www.bnm.gov.my/-/introduction-of-bank-negara-monetary-notes-istithmar.

[42] Bank Negara Monetary Notes. wikipedia.org: https://en.wikipedia.org/wiki/Bank_Negara_Monetary_Notes.

interbank market, the bank "seller" (principal) of cash resources appoints the bank "buyer" as its agent to "invest" them in the financial transactions of the agent bank for profit. The parties agree on the amount, term and expected rate of return. However, the *wakala* also contains significant contradictions to its effective use for interbank financing, as under Islamic law requirements for this contract, the agent bank cannot guarantee the principal bank the return on "investment transactions" specified in the agreement, as it is determined by its actual income at the end of the agreement. In other words, if the agent bank's actual profitability exceeds the nominal rate (as defined in the agreement), the principal bank will pay only the nominal rate (the agent bank retains the excess). If the actual yield of the agent bank is lower than the nominal rate, it is obliged to pay only this actual yield (it is exempt from compensation of the difference).

Of course, in practice, the borrowing bank must pay the nominal rate at all times at the expense of, for example, yield equalisation funds (otherwise it will not be able to continue its business), but this can significantly increase the transaction costs of such transactions, and secondly, it contradicts the *wording* of the essence of *wakala* in Islamic law.

Thus, it can be concluded that despite a significant number of developed and standardised organisational and legal forms and models of banking activities in the doctrine of Islamic finance, there are still significant contradictions and unresolved problems with respect to key economic categories, such as, for example, the definition of "margin", the use of interbank financing instruments, and effective management of bank liquidity. Moreover, in our opinion, the resolution of some contradictions within the interest-free banking paradigm is a difficult task for Islamic lawyers, economists, and financiers.

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