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Islamic financial systems and its prospects in Azerbaijan

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CONTENTS

SUMMARY

"Islamic Financial System and its Perspectives in Azerbaijan" is comprehensive and practical guide for anyone seriously interested in understanding the Islamic finance. The book published under the general editorship of Prof. Dr. Vusal Gasimli, Executive Director of the Center for Analysis of Economic Reforms and Communication of Azerbaijan, illustrates all aspects of Islamic banking, including chapters on its creation and evolution, financing instruments of Murabaha, Mudaraba, Musharaka, Ijara, Istisna'a, Islamic insurance of Takaful and bond markets of Sukuk. Finally, the book also covers the role of Sharia'a boards, developments of Islamic financial services industry in the world and in Azerbaijan.

Islamic finance has taken a dramatic surge in popularity in recent years. It is a large, dynamic and growing market. Few decades ago Islamic banks have been operating only in places such as Bahrain, Saudi Arabia, Malaysia and Dubai. Over the last three decades Islamic finance has experienced remarkable growth and the global demand for Islamic banking products and services is increasing day by day. Now most of Western conventional banks offer new ranges of financial products designed for Muslims. Today, everyone agrees that Islamic finance is expanding rapidly and this is the perfect book published in right time for anyone looking to understand the industry and offers an excellent overview of the principal concepts of Islamic finance.

The book presents the stance of applications of Islamic finance and banking in the global scale. In the wake of the recent financial crisis the debate is reignited over the development of a risk-sharing financial system. To guide policymakers in this challenging task the chapter on "Introduction to Islamic Finance: Theory and Practice" highlights the core principles of risk sharing in Islam, presenting it as a risk-sharing financial system that exactly what is needed to promote greater financial stability and economic resilience in the post-crisis era.

A comprehensive coverage of the fundamental theory behind Islamic finance and banking provided in the book clearly explains the distinct features of an Islamic financial system and traditional financial models. The book also addresses emerging issues influencing future developments in Islamic finance and dedicates a special chapter on the financial crisis, globalization, non-bank financial institutions, and recent developments in Islamic insurance.

This book also useful for newcomers of the market to understand the fundamental principles and functions of an economic, banking and financial system based on principles of Islam such as property rights principles, faithfulness to terms and conditions of contracts, trust and trustworthiness, sanctity of contracts, risk sharing, and prohibition of interest-rate based debt contracts and economic behavior of individuals, society and state in general.

Prof. Dr. Vusal Gasimli and co-authors of the book bring their theoretical knowledge and practical experience of economics, finance, banking, and capital markets and provide valuable insights on the challenges faced in the fast growing Islamic financial services industry. This book also presents Islamic finance from an institutional economics perspective and provides interlinkages related to the financial system and structure.

H.E. Zehra Zümrüt SELÇUK
the Director General of SESRIC

INTRODUCTION: ISLAMIC FINANCE AND SUSTAINABLE DEVELOPMENT

In response to global business trends, Islamic finance manages money according to Islamic principles. From my perspective, Islamic finance is one of the solutions that can address classical economic problems of justice, efficiency, and freedom. Interestingly, the Islamic financial sector adapts to global trends through South-South, North-South, and Triangular cooperation, promoting equitable distribution of resources, knowledge, and expertise. Aligned with the UN Sustainable Development Goals, Islamic finance fosters social responsibility within the ESG (Environmental, Social, and Governance) framework, and increases interest in environmentally friendly and sustainable products, particularly green sukuk. Given the significant risks posed by climate change, the Islamic finance sector adheres to principles of climate leadership, strategic climate management, integration of climate considerations into operations, performance measurement and accountability, and cooperation and knowledge exchange in climate sustainability.

Islamic finance fosters inclusivity by prohibiting riba (usury), thereby extending financial services to those traditionally excluded due to interest restrictions. It advocates for Islamic social finance instruments like waqf (endowments), zakat (almsgiving), sadaqah (voluntary charity), debt instruments, and kafala (guarantee). These transactions must align with the overarching goals of Islamic jurisprudence, Maqasid al-Shariah, which are to enhance welfare (Maslahah) and prevent harm (Mafasid), thereby promoting the public interest and common good. In an era where inequality is a global focal point of discussion, programs like Prospera in Mexico and Bolsa Familia in Brazil are striving to ameliorate poverty and foster prosperity through income redistribution. Kaitlin Brown among others has noted the challenges faced in combating poverty in Africa, highlighting the stubborn nature of this issue. Islamic social financial tools, in this regard, aim to address disparities by fulfilling the fundamental economic roles of distribution and redistribution.

Conversely, the principle of asset-based financing and risk-sharing is instrumental in the growth of micro, small, and medium-sized enterprises bolstering the middle class. Islamic financial services like Islamic microfinance, sukuk, and takaful are noteworthy in this context. Specifically, minimizing risk enhances resilience and predictability by dampening the impact of the cyclical crises that are typical of market economies.

Under Mudarabah, an equitable partnership model, one party provides capital while another manages the business, resulting in a shared distribution of profits and losses. Musharakah refers to a joint enterprise or partnership structure in Islamic finance, where all partners share the profits and losses of the business venture. Murabaha, another Islamic financing method, involves a seller and buyer agreeing on the markup of an asset. In Islamic finance, murabaha transactions replace conventional loans. Unlike traditional leases that do not culminate in a transfer of ownership, Islamic finance leases typically end with the lessee acquiring ownership. Due to the Islamic prohibition of riba (interest), al-maisir (gambling), and al-gharar (excessive uncertainty), Takaful insurance emerges as an alternative to conventional insurance, with members contributing to a pool to safeguard against each other's losses. Amid intensifying trends of deglobalization, Takaful presents new avenues for investment and trade.

The working document from the IMF records that Islamic banking, in its contemporary guise, commenced in the early 1960s with cutting-edge practices in Egypt. The Mit Ghamr Islamic Savings Associations (MGISA) effectively gathered the deposits of Muslim investors, ensuring the provision of returns in compliance with Sharia law. Subsequently, the Pilgrims Fund Corporation (PFC) facilitated a system for Malaysian Muslims to incrementally save and channel investments into Shariah-compliant avenues, aiding in covering expenses incurred during the Hajj pilgrimage. The year 1975 was pivotal for Islamic banking with the inception of the Islamic Development Bank (IDB) and the Dubai Islamic Bank, the first significant Islamic commercial bank in the United Arab Emirates.

The State of the Islamic Economy 2022 Report forecasts a 9.1 percent growth in spending within the Islamic economy sectors for 2022, despite the persistent uncertainties posed by the COVID-19 pandemic. Excluding travel, all sectors pertinent to the Islamic economy had rebounded to pre-pandemic expenditure levels by the end of 2021. These expenditures are expected to ascend to $2.8 trillion by 2025. Specifically, Islamic financial assets are projected to have reached $3.6 trillion in 2021, marking a 7.8% increase from $3.4 trillion in 2020. In 2020, Islamic banking held approximately 70 percent ($2.349 trillion) of Islamic financial assets, sukuk comprised 19 percent ($631 billion), Islamic funds accounted for five percent ($178 billion), other Islamic financial instruments represented four percent ($154 billion), and the takaful sector constituted the remaining two percent ($62 billion).

Islamic finance exhibits an intriguing ability to assimilate innovations in response to the challenges posed by the fourth industrial revolution. Embracing emerging technologies such as online and mobile banking, novel payment services, digital currency, and blockchain, Islamic finance is actively adjusting to contemporary circumstances, thereby broadening its competitive landscape.

In parallel with other competitors, The Banker notes that 2021 witnessed a resurgence of profitability for Islamic banks. Out of the 204 banks featured in this year's primary rankings, only 14 incurred annual losses, while 65 reported pre-tax profits exceeding $100 million. Notably, Sharia banks consistently outperform their conventional counterparts in terms of profitability. The 2021 rankings reveal that the return on assets (ROA) for Shariah-only institutions reached 1.43%, nearly double the global average. The focal point of Islamic banking resides in the six countries comprising the Gulf Cooperation Council (GCC), which collectively hold just over two-thirds of the world's Sharia-compliant assets. This region remains the primary driver of growth for the sector, experiencing a notable 15.16% increase in Shariah-compliant assets in 2021. Furthermore, Islamic finance has made inroads into regions such as Central Asia, North America, Asia Pacific, and Africa. Reflecting its global reach, Islamic banking is practiced in 135 countries worldwide.

Recognizing the potential for the development of Islamic finance in Azerbaijan, the co-authors have chosen to pen this book. The primary focus revolves around the dialectical unity between sustainable development and Islamic finance. The book delves into pertinent subjects such as personnel training in Islamic finance within our country, institutional development, legislative enhancements, bolstering collaboration with the world's premier Islamic financial institutions, and attracting investments through Islamic financial channels. Notably, the utilization of Islamic financial opportunities in post-conflict reconstruction emerges as a significant topic of discussion in the book.

The book "Islamic Financial System and Its Prospects in Azerbaijan" comprises a total of six chapters. The initial chapter, titled "Theoretical Foundations and Historical Development of Islamic Economy" elucidates the religious-theoretical foundations and principles of Islamic economy. It expounds on the relationship between religion and the economy and elucidates the theoretical aspects of Islamic economy, emphasizing characteristics such as flexibility, universality, and gradualism. The rules of Islamic economy are clearly delineated, with their sources identified as the Qur'an and the Sunnah, encompassing individual rulings and overarching principles. The book posits that the utilization of legal sources and methods in Islamic economics is rooted in viewing economics as an integral component of the legal framework.

This chapter further explores Islamic economy through the lens of social justice, providing an expansive discussion on concepts like the fair distribution of income, zakat, infaq, debt-hasan, and expiation. The book also addresses the concept of property in Islam and establishes the theoretical basis for state income. Interest relations are examined in both pre-Islamic and post-Islamic eras, touching on issues such as gharar, inaq, unjust profit, and waste. The intricate dynamics of the formation and development of Islamic economy, along with detailed explanations of land and agriculture in Islam, are expounded upon. Additionally, the first chapter dedicates substantial space to the emergence and evolutionary dynamics of Islamic banking.

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The second chapter of the book, titled "Islamic Financial Mechanisms" delves into various scientific-theoretical aspects, encompassing financial supply in Islamic banking, banking products, the current state of Islamic finance, leasing in Islam, social tools of Islamic finance, and the role of takaful in the development of the financial system. The chapter scrutinizes Islamic finance mechanisms based on partnership, trade, lease and social models, including mudarabah, private mudarabah, joint mudarabah, and musharakah. Within this chapter, an extensive theoretical exploration of banking products is presented. The book comprehensively analyzes the current state of Islamic finance, considering the ranking of Islamic finance countries, advanced countries based on the Islamic finance regulatory system, the global Islamic financial landscape, and the division of the Islamic financial system by main instruments. Statistical indicators of Islamic financial assets in different countries are also examined. Leasing relations are assessed in both traditional and Islamic economies, with leasing recognized as a prominent aspect of Islamic economic relations. The chapter underscores the role of securities, particularly sukuk, as the primary component of the Islamic capital market. Given the non-compliance of traditional capital market instruments with Islamic principles, the issuance of Sharia-compliant securities, notably sukuk, is highlighted. The second chapter further elucidates the meaning and main principles of gharzi-hasan and zakat, offering an explanation of the essence of sukuk. The dynamics of the global sukuk market formation are analyzed based on statistical indicators from various countries. Lastly, the chapter explores the role of takaful in the development of the Islamic financial system, elucidating its theoretical basis and analyzing the developmental dynamics of the global takaful market using statistical data from diverse countries. It emphasizes that takaful operations, considered Islamic insurance, are grounded in risk-sharing rather than risk transfer. In this context, the insurer plays a coordinating role in distributing risks among the insured, without assuming the insurance risk.

The third chapter of the book, titled "Islamic Commercial Laws and Corporate Governance Standards in Islamic Financial Institutions" encompasses various topics, including Islamic commercial laws, types of contracts and laws in Islam, Sharia committees in Islamic financial institutions, and accounting and corporate governance in the Islamic financial system. This chapter delves into the theoretical and practical aspects of contracts such as tabarru, ibra, bey sale, amanah, musawama, as well as rights transfer contracts and cooperation contracts. Additionally, it provides a detailed analysis of the role and duties of Sharia committees, along with the regulatory, accounting, and auditing standards applied in their activities.The chapter emphasizes that the Shariah Control Committee, functioning as an efficient control unit, initiates its activities with the appointment of independent members. Beyond approving the types of products and services, committee members ensure the application and interpretation of Sharia laws related to their activities. Reports on the activities of the Islamic Financial Institute (IFI) offer a comprehensive public opinion on Sharia issues. The book notes that IFI's Accounting and Audit Organization (AAOIFI) oversees the regulation of Shariah control rules, formulates and implements accounting and auditing standards. The third chapter clarifies the scope of Shariah audit, distinctive features of the Shariah oversight committee and internal Shariah audit, characteristics of AAOIFI financial statements, and the functions of the audit and management committee.

The fourth chapter of the book, titled "The Role of Islamic Finance in the Development of the Global Financial System" extensively analyzes the contemporary state of Islamic financial services, scrutinizes the sustainability of the Islamic financial system, and investigates global opportunities in the realm of financial services. This chapter evaluates the current state of Islamic financial services based on statistical data, delves into investment in this sector, and examines the dynamics and scale of financial services development using examples from the United Arab Emirates, Malaysia, Indonesia, Egypt, and Saudi Arabia. A comparative analysis is drawn between traditional financing and Islamic finance in terms of efficiency, risk, risk management, and other theoretical bases and principles within the Islamic financial system. Simultaneously, the chapter describes the system of indicators for assessing the stability of Islamic banking, offering an explanation of the theoretical and methodological basis for calculating these indicators. The book underscores that the growing demand among Muslims for a Shariah-compliant financial system is propelling the expansion of Islamic finance. Many Muslims, even residing in non-Islamic countries, naturally seek alternative financing methods upon realizing that interest payments in traditional banking conflict with the prohibited concept of riba. This realization serves as a driving force for the development of the Islamic financial system.

The fourth chapter delves into the macroeconomic consequences of Islamic finance, conducting extensive scientific-theoretical analyses on various fronts such as financial stability, fiscal and monetary policy, macroeconomic management, and liquidity problems. Takaful and the Islamic capital market undergo comprehensive analysis with reference to specific figures, and the impact of the Fourth Industrial Revolution on Islamic finance is considered. The text notes that the Fourth Industrial Revolution, characterized as a digital technological revolution, influences the speed, scope, and systems of services by providing access to unprecedented processing power and storage capacity. In its entirety, the observed rapid digitization and fundamental changes in the banking business present both opportunities and challenges for the Islamic banking sector. The potential for sustainable growth in the Islamic banking industry over the long term hinges on its capacity to innovate and efficiently (flexibly) address the banking needs of its target customer base.

In this chapter of the book, simultaneous analyses are conducted on the opportunities for the development of Islamic financial services globally, using the example of Small and Medium-sized Enterprises (SMEs) that favor Islamic finance in Saudi Arabia, Morocco, Yemen, and Iraq. The global perspectives of Islamic financial services are elucidated, drawing on the dynamics outlined with concrete figures.

In the fifth chapter titled "Overview of the Azerbaijani Banking System and the Prospects of the Islamic Financial System," the activity of the Azerbaijani banking system is thoroughly investigated and analyzed based on extensive statistical data, providing insights into the prospects of the banking system. This chapter delves into the examination of Islamic banking and the functions of the Central Bank, elucidating the potential applications of Islamic banking. Introducing the Islamic financial system in Azerbaijan involves various opportunities and perspectives, including the integration of Islamic banking into the existing system. The chapter also outlines the future prospects and challenges of Islamic finance in Azerbaijan, emphasizing the broad and diverse development potential and market opportunities for Islamic finance in the country. The favorable environment for the expansion of Islamic finance is attributed to the diversification of the country's economy, financial inclusion, and a commitment to sustainable development. To fully leverage these opportunities, addressing regulatory frameworks, raising awareness, fostering product innovation, and developing human capital are deemed critical. With a strategic approach and supportive policies, Islamic finance has the potential to flourish in Azerbaijan, contributing to the economic growth and social welfare of the country.

In the final chapter of the book, Chapter six, the results and recommendations derived from the research and analysis are presented. The book, with its rich information and comprehensive analyses on the current situation and prospects of Islamic finance, holds practical and theoretical significance. The research indicates a significant correlation, in the long run, between Islamic bank assets, Islamic bank financing, and Islamic bonds with the real GDP in Muslim countries.

The authors believe that this book, serving as an educational resource on the fundamentals of Islamic finance, will be an essential tool in higher education institutions. Additionally, it is anticipated to be of interest to decision-makers, business professionals, and academic circles alike.

Vusal Gasimli

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