

“Islamic finance as an innovative tool for the Volga region real economy development”

AUTHORS	Angela Igonina Mikhail Postaliuk
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Angela Igonina (Russia), Mikhail Postaliuk (Russia)

## Islamic finance as an innovative tool for the Volga region real economy development

### Abstract

This paper deals with the Islamic finance as innovative method of the real economy development in the Volga region, Russia. The development of Islamic finance institutions in the global economy is considered. To estimate the total volume of Islamic banking assets correlation and regression analysis technique is applied. Prospects of the Islamic finance implementation in Volga region is analyzed.

**Keywords:** Islamic finance, Islamic banking, correlation and regression analysis, real economy, economic growth, Islamic bonds (sukuk).

**JEL Classification:** G20, O16.

### Introduction

Islamic finance is based on Sharia, the Islamic law that provides guidelines for multiple aspects of Muslim life, including politics, business, economics, banking, religion and different aspects of the legal system. In other words, *Sharia* represents how practicing Muslims can best lead their daily lives in accordance with God's divine guidance.

Major financial principles of Sharia include a ban on uncertainty (gharar), a ban on interest (riba), a ban on gambling (maysir), adherence to risk-sharing and profit-sharing, promotion of ethical investments that enhance society and do not violate practices banned in the *Quran* and tangible asset-backing. But we can say that three fundamental prohibitions in Islamic finance are gharar, riba and maysir. Gharar is a complex concept that covers certain types of uncertainty in a contract (for example, it is extended to such conventional financial practices as short selling, swaps, speculation, futures and derivatives). Maysir is a gambling or speculation prohibited by Islamic law. Riba (usury) is a term for the prohibition of interest on money, it's strictly prohibited in the Islamic tradition.

Islamic finance and Islamic institutions nowadays is rapidly increasing in the international financial system. Not only the Islamic banking sector on the Muslim-majority states and countries, but also extended to penetrate new regions in Central Asia and Europe [1, 5], and that is working, many of which are on the development of regulatory reforms and appropriate legal that would facilitate the provision and delivery of Islamic financial services.

Developments in the Islamic finance industry in the last four decades have significant impact on both economies of Muslim geography and global financial markets. These developments starting from

the introduction of Islamic finance indices in conventional financial markets in the equity side of these capital markets followed by financial innovation such as sukuk issuances. In the past few years, the Islamic financial markets and financial instruments have made great advances. The basic Islamic asset since 2007 has grown by 140-150% and is predicted to reach \$1.8 trillion this year. It is more important that this growth is attended by a promise of far greater stability and strength than the conventional financial instruments and institutions provide.

The Islamic financial sector is still very modest compared with the traditional economic sector up to date. It's expected that Islamic finance and Islamic banking sector stagger along, particularly with respect to the development of new products and services as also open up new markets in different states and countries. The Islamic sector has proven its adjustability during the international economic crisis. For this reason building a stronger, more stable international financial system would make the world less vulnerable to mitigating financial crises and Islamic financial instruments could help it.

Islamic finance attracted some of the international companies to tap this new capital source, especially for leasing and project financing. The major names are IBM, General Motors, Xerox, France's Alcatel and Daewoo. They all raised money through Islamic leasing funds set up by the United Bank of Kuwait.

In accordance with The World Bank, by 2025, emerging economies – such as China, India, Brazil, Indonesia, and the Russian Federation – will be main contributors to international growth, along with the advanced economies [11]. It's expected that Islamic finance and Islamic banking system encourage developments to stimulate alternative forms of financial intermediation, supported by growing demand for banking products and services alternative. It is necessary to develop the Islamic banking system in various countries to accelerate the development of market instruments for the purpose of meeting liquidity requirements.

In spite of the positive records of achievements that have been done due to the retrograding international economic environment, but the shortage of education and awareness about products and services in some countries and regions, as well as legal and tax matters are among the challenges that will be faced by the Islamic finance and banking sector.

This paper deals with the Islamic finance as innovative method of the real economy development in the Volga region (Tatarstan, Russian Federation) and investigates the prospects of the Islamic finance implementation in this region. In this investigation we gave an explanation of why Tatarstan can become a successful launch pad for the development of Islamic finance in Russia.

We have shown trends of the most rapidly and successfully developing sectors of the economy in the region, and have also named the top-priority economic projects in the region that might interest potential investors from the Arab-Muslim world *in the light of specific features* of the Volga region. Also we have investigated at what stage is the development of Islamic finance in Russia.

Our analysis considers the development of Islamic finance and Islamic institutions in the world economy too. In this paper we can see the trends of the Islamic finance development in the world until 2018 as well as main economic performances and their characteristics. To estimate the total volume of Islamic banking assets we applied the correlation and regression analysis technique. In this regard we constructed regression equation and showed how the total volume of Islamic banking assets changes due to different correlated factors (variables).

## 1. Literature review

In recent times the development of Islamic finance and its elements has aroused increased interest by many scholars. The theoretical concept of Islamic finance is formed on the basis of the works of early Islamic thinkers. The major contribution has been made by such scholars as al-Ghazali, Ibn Taymiyyah, Ibn Khaldun, Ibn Qayyim al-Jawziyya.

Among modern foreign scholars and theorists who study the issues of Islamic finance development are Dr. Muhammad Umer Chapra who has written on the issues of Islamic economics and perspectives of prospects of the Islamic finance implementation in different countries. Dr. Zamir Iqbal and Dr. Abbas Mirakhor ("An Introduction to Islamic Finance: Theory and Practice", 2011) are leading scholars of Islamic finance, its principles and special aspects.

Significant contribution to the study of the theory of Islamic finance and its development and implementa-

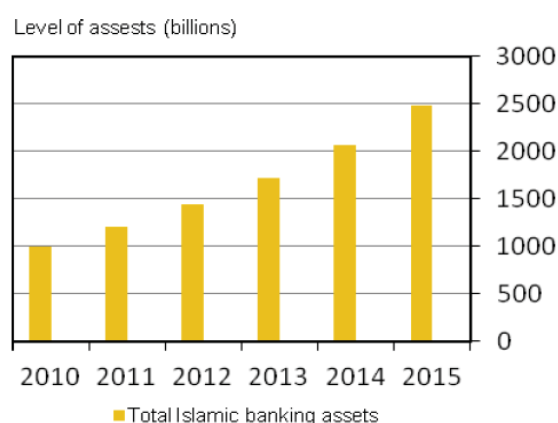
tion in Russia made by such Russian scientists and economists as Biryukov, E. and Zhdanov, N., Bekkin, R., Syukiyaynen, I., Zhuravlev, A., Pavlov, V. Hadiullina G. explored the subject of Islam's influence on the socioeconomic views of Tatar Diaspora, etc.

## 2. Islamic finance in the international financial system

Islamic markets offer different instruments to satisfy players in the market in a variety of ways: trade financing, investment and sales. Main instruments in Islamic finance are profit-sharing (*mudaraba*), leasing (*ijara*), partnership (*musharaka*), forward sale (*bay'salam*) and cost-plus financing (*murabaha*). These instruments are the basic component parts for developing a wide range of more complex financial instruments, suggesting that there is great potential for financial innovation and development in Islamic financial markets. As previously mentioned, the basic principle in the Sharia, the Islamic law, is that contracts based on *gharar* (speculation) or *riba* (interest) are unenforceable, though the Koran doesn't prohibit fair profits.

By 2013, there were more than 600 Islamic financial organizations operating in more than 75 countries (only 57 of them are Islamic states) [2,19]. In 2013 their total financial assets exceed \$1.7 trillion (2011: \$1.3 trillion) [13,19]. The Islamic banking industry in the world has grown at a strong rate of between 15% to 20%. According to Ernst and Young's World Islamic Banking Competitiveness Report 2013-2014 [19], the Islamic banking sector continues its robust growth, with the top 20 Islamic banks registering an increase of 16% in the last three years. It is likely to become more and more important financial market in the future.

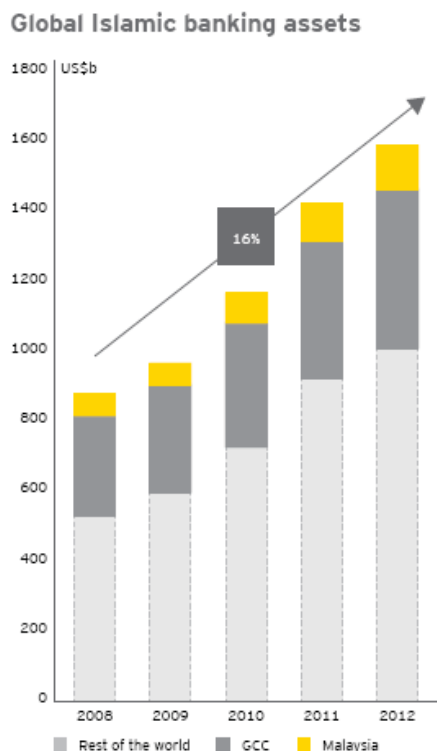
By 2015 the Islamic banking industry forecasts to be worth nearly \$2.5 trillion (Figure 1). Globally, it is expected that the Islamic banking assets will grow to \$3.4 trillion by 2018 [19].



Source: The Banker.

Fig. 1. Islamic banking growth potential

Islamic banking assets with commercial banks are suggesting globally an annual increase of 16% over last five years (Figure 2). By 2018 Islamic banking profit pool could reach \$26.4 billion or 48% of the banking system profits across QISMUT countries [19] (six rapid-growth markets including Qatar, Indonesia, Saudi Arabia, Malaysia, UAE and Turkey) (2012: \$9.4 billion).



Source: Ernst and Young (2013).

**Fig. 2. Global Islamic banking assets**

In 2012 total Islamic bonds (sukuk) issuance reached \$131 billion (2003: \$5 billion), an increase of 54 percent on the previous year. Malaysia continued to dominate the market of sovereign sukuk issuance while other top countries in sukuk issuance [3, 19] were Saudi Arabia, UAE and Indonesia.

Islamic financial industry is a relatively new sector but it is growing fast and steady over the past few years as all the above-mentioned graphs demonstrate.

The Islamic financial system nowadays has risen to such a level that it cannot be ignored; it plays an increasingly important role in the global economy. We should be aware of these innovative tools to understand exactly how they work to be able to choose a new, alternative economic development. These innovative tools can contribute to both global economic growth, the world economy and the growth of the Russian economy, in particular, the Volga region.

The main feature of an innovation-driven economy is the efficient functioning of the financial and

banking institutions in collaboration with the real sector [17, 18] of the economy to ensure its resources. Consequently, a key concern in terms of innovative development of the economy is to be the organization of real and banking sectors constructive engagement. Islamic finance is primarily marked by the fact that they meet the needs of the real economy.

With their emphasis on equity and investment in the real economy, the principles of Islamic finance provide a stable and efficient banking sector. Rather than providing a profitable financial alternative to investing in the real economy [9, 17], Islamic banking industry supplies and intensifies the latter. It ensures that financial capital does not lead to artificially bloated asset prices. Instead, it is made to work in the real economy, on real projects.

Consequently the main quality of Islamic financial assets is their stability and equivalence with the real economy's assets where there is no place to the virtual speculative capital flow. This means that all the operations of Islamic financial institutions actually generate added value in the exchange of goods and services of key industries of any country, they have a transparent and conservative, free from corruption and moral damage and become inherently investment content, which, in turn, is not typical for conventional banks. For example, unlike Eurobonds, mutual Sukuk bonds are tied to tangible assets, to the specific projects of the real economy; they are designed for profit and loss sharing. It is beneficial and fair for both issuers and shareholders.

### 3. Dependence of the total volume of Islamic banking assets from different variables by applying correlation analysis and regression modelling

Take a detailed look at the most closely-influencing factors due to which total size of the international Islamic banking assets may be increased. In this regard correlation and regression analysis technique is applicable. The main factors that determine the volume of total banking assets of Islamic banks are: the number of Islamic banks; the number of Islamic windows; the number of the Muslim population; the number of countries in which operates Islamic banking.

In this analysis the response value is the total volume of Islamic banking assets. And the variable parameters are above-mentioned factors which can influence on the volume of total banking assets of Islamic banks.

To estimate the relationships among variables we need to build a correlation matrix based on the following data presented in Table 1.



Table 1. Data for the correlation analysis

Year	Total Islamic banking assets, trillion dollars	Islamic Banks, units	"Islamic Windows", units	Muslim population, million people	Countries where Islamic banking exist, units
1	2	3	4	5	6
2007	505	362	163	1235	39
2008	639	420	194	1359	44
2009	822	435	191	1547	49
2010	894	456	199	1610	51
2011	1033	512	161	1625	53
2012	1173	549	145	1757	54
2013	1352	593	110	1813	56

Note: A table was formed by the authors from the data that was found from different economic reports and statistical journals which are listed in the references below.

Using Excel's Correlation data analysis tool we can compute the pairwise correlation coefficients for the various variables in Table 1. The results are shown in Table 2.

Table 2. Matrix containing pairwise correlation coefficients

	y	x <sub>1</sub>	x <sub>2</sub>	x <sub>3</sub>	x <sub>4</sub>
y	1				
x <sub>1</sub>	0.789187511	1			
x <sub>2</sub>	-0.70641563	-0.728477571	1		
x <sub>3</sub>	0.777106748	0.749027126	-0.555738692	1	
x <sub>4</sub>	0.759244254	0.635806924	-0.486822971	0.786530015	1

Next, using the program GRETL, we received the data and the regression coefficients. Conclusions of the analysis and calculation of the statistical regression are shown in Table 3 below.

Table 3. Model "Dependence between Y and x<sub>1</sub>, x<sub>2</sub>, x<sub>3</sub>, x<sub>4</sub>". Dependent variable: Y.

	Coefficient	Std. error	t-ratio	p-value
Const	709.644	85.9327	-8.2581	0.01435***
x <sub>1</sub>	0.876304	0.393436	2.2273	0.15580**
x <sub>2</sub>	-1.77088	0.419843	-4.2180	0.05187***
x <sub>3</sub>	0.54787	0.179518	3.0519	0.09268***
x <sub>4</sub>	13.1	7.24831	1.8073	0.21245**
Mean dependent var	916.8571	S.D. dependent var	295.7473	
Sum squared resid	317.0448	S.E. of regression	12.59057	
R-squared	0.999396	Adjusted R-squared	0.998188	
F(4, 2)	827.1415	p-value (F)	0.001208	
Log. likelihood	-23.27854	Akaike criterion	56.55707	
Schwarz criterion	56.28662	Hannan-Quinn	53.21437	

According to Table 3 the value R-squared (which is also called a level of certainty or the coefficient of determination) is a statistical measure of how close the data are to the fitted regression line. R-squared refers to the fraction of variance explained by a model. According to the analysis R-squared value nearing 1.0 and is 0.999, it is high so that means the Independent variable we have chosen is capable enough to explain variation in Dependent variable.

Multiple correlation coefficient R (adjusted R-squared from the table above) – represents the level of dependence of the independent variables X and the dependent variable Y. The coefficient of multiple correlation is a measure of how well a given variable can be predicted using a linear function of a set of other variables. In our case the adjusted R-squared is 0.998, it means the relationship between the variables is very high.

From the analysis above we have the following regression equation:

$$Y = 1047.644 + 0.87 \times x_1 - 1.77 \times x_2 + 0.54 \times x_3 + 13.1 \times x_4.$$

On the basis of this model, we can say that by increasing in the number of Islamic banks by one unit the total assets of Islamic banks go up to \$0.87 trillion. An increase in the number of "Islamic windows" by one unit the total assets of Islamic banks go down by \$1.77 trillion, an increase of the Muslim population by 1 million the index goes up by \$0.54 trillion. And according to equation, with the growth of a number of countries where Islamic banks operate by one unit, the amount of the total assets of Islamic banks increased by \$13.1 trillion.

The practical implications of the constructed equation is that analyzing and controlling the parameters included in the equation as independent variables it is possible not only to evaluate the volume of the total assets of Islamic banks, but also to predict their future prospects.

Mathematic economic model built with the correlation and regression analysis shows us how the amount of the total assets of Islamic banks changes depending on the factors which are correlated with each other: such as the number of Islamic banks, "Islamic windows", Muslim population and the number of countries where Islamic banks operate.

#### 4. Islamic finance in the Volga region, Russian Federation

Islamic financial institution development in Russia intended to address an important long-term goal –

the modernization of the financial market of the country and reducing the share of toxic assets and speculating transactions.

Concerning Islamic financial institutions in Russia, we first need to understand that successful integration of the Islamic instruments into the real economy need a set of assumptions, which are based on a proper understanding of the business community about the nature of the functioning of the Islamic economic model, Islamic finance and financing methods. The most appropriate region for Islamic finance development and implementation in Russia is the Volga region, in particularly Republic of Tatarstan where according to estimates more than 50% of Muslims live. In Russia, according to various estimates there is Muslim population of between 15 to 25 million (about 10 and 18% of the population, respectively) which is forecasted to reach 30 percent by 2050.

According to an official estimate for 1 October 2013, the total population of Russian Federation was recorded at 143.6 million [12]. According to the 2010 census ethnic Russian people make up 81% of the total population. Six other ethnicities have a population exceeding 1 million: Tatars (3.9%), Ukrainians (1.4%), Bashkirs (1.1%), Chuvashs (1%), Chechens (1%) and Armenians (0.9%). It should be noted that among above-mentioned nationalities, Tatars, Bashkirs, Chechens are Muslims.

Islamic world's investors are searching for investment opportunities in the emerging markets that would satisfy Shariah law. It is considered that Tatarstan located in the Volga Region is capable to become a center of the Islamic Finance in the CIS region. The growing interest of Tatar companies in Shariah compliant business reflects the Tatar Government's commitment to promoting Tatarstan, where Muslim population reaches 52%, as Russia's Islamic finance centre and an attractive place for Muslims to do business.

The Tatarstan Investment Development Agency (TIDA), together with the Thomson Reuters Agency, has developed a five-year plan for the creation of a Regional Center for Islamic Finance of Russia and the CIS in Kazan, the capital of Tatarstan [13, 15].

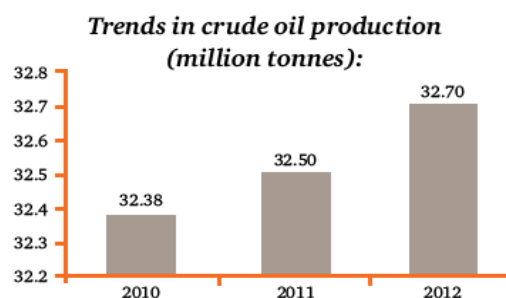
According to estimates developed by Thomson Reuters, the CIS countries during this period may raise about \$29 billion in investments from Malaysia and countries of the CCASG (Cooperation Council for the Arab States of the Gulf) [13]. To conform the financial flows, the developers plan to create a regional regulatory bank in the capital of Tatarstan, Kazan.

The main objective of the project is to accelerate the development of Islamic finance in the Russian Federation by ensuring alternative institutions to conventional banks, not just for the Muslims, but also for people of other faiths. The experience of the U.K. has already shown this, as 70-75 percent of borrowers of funds from Islamic banks are non-Muslim population. In fact, Islamic financial instruments are tools for attracting investments from Muslim countries. This is not a matter of investments into industry or sector, but rather of attracting financial flows through financial institutions.

Kazan has been chosen as the hub for Islamic investments because Tatarstan has accumulated considerable experience in international projects and contacts with investors from Muslim countries. Besides traditional close economic and trade ties with the region of the Middle East, the foreign policy of rapprochement with Islamic countries, including Russia as an observer to the Organization of the Islamic Cooperation (OIC) require further development of relations in the financial and economic sector.

According to the experts, Islamic investors are showing interest in Russia due to both economic and geopolitical factors. Alberto Brugnioni, chairman of the Italian non-profit organization ASSAIF, says: "Muslim investors simply cannot ignore Russia due to its huge size, raw material resources, the size of its Muslim population and its proximity to several strategic Muslim countries in Central Asia" [13].

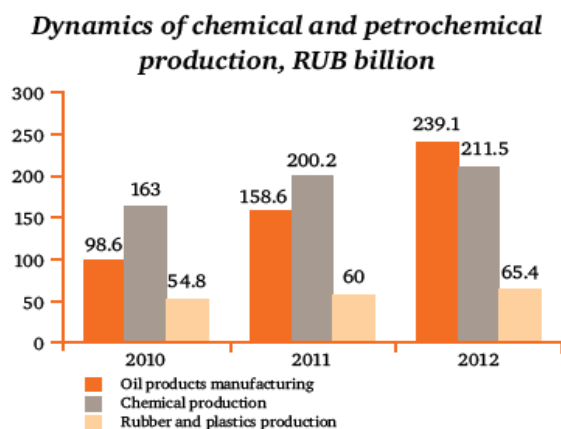
As for the areas of investment in accordance with the expert conclusions, it will be the real sector; primarily this will be infrastructure and oil refining. Islamic finance is closely linked to the real sector of the economy. It has been estimated that Russia needs more than \$1 trillion of investments into infrastructure over the next 10 years, and Islamic finance fits perfectly well into these volumes [4, 15]. Investments into agriculture may be attractive to Islamic partners, for example, in the Volga Region, where they can participate in small inexpensive projects. Tatarstan produced 32.7 million tonnes of oil in 2012, representing a growth of 0.6% (Figure 3).



Source: PWC (2013).

**Fig. 3. Trends in crude oil production**

The chemical and petrochemical industry – including chemical production, rubber and plastics production, and petroleum product manufacturing – is a key driver to the economic growth of Tatarstan, the Volga region (Figure 4).



Source: PWC (2013).

**Fig. 4. Dynamics of chemical and petrochemical production**

According to EXPERT RA Rating Agency<sup>1</sup>, Tatarstan, the Volga Region is among those regions that have minimal risk in administrative and financial spheres and maximum potential for investments [7].

Since 2009 the annually held KazanSummit arranged by Islamic Business and Finance Development Foundation and Tatarstan Investment Development Agency has proved to be one of the most effective events for expanding the economic ties between Russian Federation and Islamic countries. In fact, in 2010 sukuk, or sovereign Islamic bonds, were issued in Russia, Tatarstan [2, 3, 16]. It was agreement between Malaysia, Tatar Government, Amanah Raya Berhad Investment Bank, Kuwait Finance House and LinovaInvestment Finance Company (Russia). Nowadays Tatarstan is going to borrow some US\$200 million through sukuk.

It is expected the market to have significant growth in after years. According with the recent research by Ernst & Young the dramatic development – including “the Arab Spring”, Eurozone crises and “Occupy Wall Street” movement – provide further impetus for the growth of Islamic banking.

But there are still quite a few problems which are needed to be overcome towards development of Islamic banking in the Volga region, Russia. Lending in Russian banks is based on the principle of serviceability, maturity and repayment. Serviceability means payment of accrued interest on a loan, which, according with the Islamic law, is

forbidden for financial institutions and individuals. The concerns is the absence of an enabling legislative, regulatory environment that could allow Islamic financing in the Russian Federation. Experts also admit that where conventionally structured products are relatively straightforward, similar Islamic financial products tend to be more complex. Shariah compliance often leads to additional requirements in the structuring process which in turn leads to higher transactional costs [12].

However, some steps for Islamic finance development was already done. In 2010 in Russia, the Tatarstan International Investment Company along with the Saudi Arabia-based Islamic Development Bank were set up to increase private Shariah-compliant assets and capital. It established the Eurasia Leasing Company and now Muslim and Non-Muslim organizations in Russia are able to make use of Islamic leasing products. AK BARS Bank, a Kazan-based lender, obtained a \$60 million Shariah-compliant loan in September 2011 to fund a transport development proeject in the Volga region. AK BARS Bank’s Islamic deal was awarded the title of “Deal of the Year 2011 in Europe”. In the future, there will be two satellite cities in the capital of Tatarstan: Innopolis and Smart City Kazan. Companies from Southeast and the Middle East of Asia are actively participating in the development of the above-mentioned project.

Islamic finance and Islamic banking in particularly should be considered as a supplementary device of attracting financial resource and boosting economic processes in the Volga region.

## Conclusions

Islamic finance and Islamic financial institutions are fast becoming a major global force and their impact is only just beginning. We all learned lessons from the recent Global financial crisis and now it’s time to evaluate the possibilities of alternative financial instruments to promote economic prosperity of through the financing of real economic activity, which is completely in line with the objectives of Islamic finance.

The evolution of market instruments in particular as a major factor contributing to the leadership of Islamic finance, and instruments and became an important way to raise funds globally, as well as stimulate investment activities and generate substantial financial flows from abroad.

With the internationalization of this sector, it is expected to contribute to Islamic finance in a more efficient move and the distribution of funds to various regions. This will enhance the trend of financial and economic links between the various global countries, bringing and achieving mutual benefits for all shareholders and owners of capital.

<sup>1</sup> The rating on investment attractiveness of the regions in Russia is conventionally based on official information given by Russian Federal State Statistics Service and statistics given by federal offices. The rating used statistical data as of 1 January 2013.



The growth of Islamic banking services has many positive effects on the world economy. First, this sector is linked to the financing of real assets through the purchase and sale of goods to ensure utilization of the funds in real economic activities. Second, more transparency of Islamic banks than traditional ones plays a positive role in the economic growth and development. In our paper we applied correlation and regression analysis technique to estimate the total volume of Islamic banking assets. Regression equation showed us how the amount of the total assets of Islamic banks changes depending on the factors which are closely correlated with each other: such as the number of Islamic banks, "Islamic windows", Muslim population and the number of countries where Islamic banks operate. The practical implications of the constructed equation is that analyzing and controlling the parameters included in the equation as independent variables. It is possible not only to evaluate the volume of the total assets of Islamic banks, but also to predict their future prospects.

Russia, in particular the Volga region, has all the necessary traits and significant potential for developing Islamic financial organization, institutions and products. The interest in Islamic financing in Russia is determined by both economic and cultural factors. Understanding the importance of the economic

component, the main is the cultural aspect due to Muslim-majority regions in Russian Federation. That is why the first steps in developing of Islamic financial system in Russia was taken in the Volga region, republic of Tatarstan where 52% of population are Muslims. On the one hand, the republic is one of the most economically developed regions of the country; on the other hand, it is a land rich with Islamic tradition. Of course, it is psychologically easier for businessmen from the Middle East to establish contacts with Russia through the Volga region, Tatarstan. Creation of settlement and financial institutions in compliance with Shariah will be well received by the Islamic segment of Russia's population.

In other words, methodological development of the Islamic financial sector, along with banks and insurance companies, investment funds, asset management companies, consulting firms will provide an opportunity to create channels inflow of direct investments in the real economy in the Volga region.

With the growing importance of Islamic banks and Sharia-compliant financial innovation, it will be increasingly important to ensure sound Islamic financial institutions going forward. The development of the Islamic financial services industry may cause the development of other sectors of the economy, causing a multiplier effect.

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