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Sharing of Risks in Islamic Finance

Ahmet SEKRETER

Abstract

For most of the people the prohibition on interest is the well known part of Islamic finance. Indeed, the concept of Islamic finance was not being discussed enough till financial crisis, after crisis it started to be seen as an alternative financial system for conventional finance. Sharing the risks is the main concept of Islamic finance and one of the main differences between conventional and Islamic finance. Depositors/savers do not bear any risk in conventional finance however Islamic finance has another solution which is called PLS (profit-loss sharing). Risks and profits between the parties involved in any financial transaction are shared by both financial institutions and depositors/savers with a pre-decided ratio.

Keywords: Islamic finance, conventional finance, profit-loss sharing system

JEL Classification Codes: G20, G21

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Introduction

“We face the question of whether the Islamic Law of Contract is resourceful enough to cover the vast variety of contemporary commercial contracts, or whether it only contemplates some limited form of transactions that were practiced in early Muslim Communities. How should the Muslim scholar face the commercial reality of the marketplace of the present day and age?” (Professor Dr. Mohammad Hashim Kamali, *Islamic Commercial Law*, Kuala Lumpur, 2002).

Islamic finance is any finance that is compliant with the principles of Islamic law (Shari'ah). In terms of finance, Shari'ah explains in details the ethical concepts of money and capital, the relationship between risk and profit and the social responsibilities of financial institutions.[1]

Standard & Poor's define Islamic finance based on five pillars as;

The ban on interest

Interest must not be charged or paid on any financial transaction, as interest (or the intrinsic value of the money) is deemed unlawful by Sharia.

The ban on uncertainty or speculation

Uncertainty in contractual terms and conditions is forbidden. However, risk taking is allowed when all the terms and conditions are clear and known to all parties.

The ban on financing certain economic sectors

Financing of industries deemed unlawful by Sharia--such as weapons, pork, and gambling—is forbidden.

The profit- and loss-sharing principle

Parties to a financial transaction must share in the risks and rewards attached to it.

The asset-backing principle

Each financial transaction must refer to a tangible, identifiable underlying asset.

Major instruments of Islamic finance

Murabahah

This concept refers to the sale of goods at a price, which includes a profit margin agreed to by both parties. The purchase and selling price, other costs, and the profit margin must be clearly stated at the time of the sale agreement. The bank is compensated for the time value of its money in the form of the profit margin. This is a fixed-income loan for the purchase of a real asset (such as real estate or a vehicle), with a fixed rate of profit determined by the profit margin. The bank is not compensated for the time value of money outside of the contracted term (i.e., the bank cannot charge additional profit on late payments); however, the asset remains as a mortgage with the bank until the default

is settled.[2]

Istisna

Istisna is the second kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser. If the manufacturer undertakes to manufacture the goods for him, the transaction of Istisna comes into existence. But it is necessary for the validity of Istisna that the price is fixed with the consent of the parties and that necessary specification of the commodity (intended to be manufactured) is fully settled between them.

The contract of Istisna creates a moral obligation on the manufacturer to manufacture the goods, but before he starts the work, any one of the parties may cancel the contract after giving notice to the other. But after the manufacturer has started the work, the contract cannot be cancelled unilaterally.

However, the party placing the order has the right to retract if the commodity does not conform to the specifications demanded.[3]

Ijara

Ijarah means lease, rent or wage. Generally, Ijarah concept means selling the benefit of use or service for a fixed price or wage. Under this concept, the Bank makes available to the customer the use of service of assets / equipments such as plant, office automation, motor vehicle for a fixed period and price.[4]

Musharakah

Musharakah is a relationship between two parties or more, of whom contribute capital to a business, and divide the net profit and loss pro rata. This is often used in investment projects, letters of credit, and the purchase or real estate or property. In the case of real estate or property, the bank sets an imputed rent and will share it as agreed in advance. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions. This concept is distinct from fixed-income investing (i.e. issuance of loans).

Sukuk

Sukuk is the Arabic name for a financial certificate but can be seen as an Islamic equivalent of bond. However, fixed-income, interest-bearing bonds are not permissible in Islam. Hence, Sukuk are securities that comply with the Islamic law and its investment principles, which prohibit the charging or paying of interest. Financial assets that comply with the Islamic law can be classified in accordance with their tradability and non-tradability in the secondary markets.[5]

Takaful

Takaful is an alternative form of cover that a Muslim can avail himself against the risk of loss due to misfortunes. Takaful is based on the idea that what is uncertain with respect to an individual may cease to be uncertain with respect to a very large number of similar individuals.[6]

Muqarada

This technique allows a bank to float what are effectively Islamic bonds to finance a specific project. Investors who buy muqarada bonds take a share of the profits of the project being financed, but also share the risk of unexpectedly low profits, or even losses. They have no say in the management of the project, but act as non-voting shareholders.[3]

Salam

Salam literally means 'futures'. A buyer pays in advance for a designated quantity and quality of a certain commodity to be delivered at a certain agreed date and price. It is limited to fungible commodities and is mostly used for the purpose of agricultural products by providing needed capital prior to delivery. Generally, Islamic banks use a Salam contract to buy a commodity and pay the supplier in advance for it, specifying the chosen date for delivery. The bank then sells this commodity to a third party on a Salam or installment basis. With two Salam contracts, the second should entail delivery of the same quantity and description as the first contract and is concluded after the first contract (El-Gamal, 2000).[7]

Total assets of Islamic banking worldwide estimated at about \$250 billion, and are expected to grow by about %15 per a year.[8]

In conventional finance there are lenders and borrowers, in the other hand in Islamic finance there are buyers and sellers. In Islamic finance any item which is wanted to buy is bought by institution and sells to client, for example you want to buy a house, Islamic bank buys the house for you and re-sell it by adding profit instead of loaning money. This way is the very common way to get profit for Islamic banks. Islamic banks are aiming to make profit like conventional banks. Profits are distributed to savers/depositors according to pre-defined ratios. Of course savers/depositors acquiesce when Islamic banks declare loss. However Islamic institutions are not declaring any loss in practice and The Islamic banks think that if the bank declares a serious amount of loss or even in the case of very low profit rates, the clients or savers can withdraw the money that they save in the bank. So Islamic banks use profit equalization reserve to protect clients/depositors' income against the reduction. So when Islamic banks believe the rate of returns will be very below the interest rates they can use their reserve to increase the return rates. Another issue is similarity between profit rates and interest rates. Transparency in Islamic finance is a vital issue for Islamic concept of sharing of risks.

Transparency

Transparency in Islamic finance is no difference between financial theories and operational practices, no hidden agendas, and the reliable information about the distributed profit by Islamic financial institutions, contracts, investments, and all financial activities for the clients and savers.

There must be some standards for transparency which should be agreed, widespread and easy to establish. Of course these standards must provide "Shariah". This would be in the interests of consumers. Some services can be established to protect consumers in Islamic finance. So these services can check the implementation of standards.

The implementation of Islamic finance products should be supported by documentation and consumers should be aware of that greater transparency will be in the interests of them. The main issue is who will standardize the standards. Indeed standards already exist in Shariah, so the process will be standardized. After deciding who will standardize then it must be known that only the process will be standardized.

These standards will bring extra responsibilities Islamic finance services. Islamic finance services should comply with these standards. There should be some partners who work with these services and consumers. So partners can feedback on the decided standards.

These partners can help Islamic financial institutions explaining the support for the standards and its requirements. These partners can evaluate whether an Islamic financial institution seeking to comply with the standards actually met the standards' requirements. If partners have reasonable opinions, determines that the institution complies the standards.

A number of service providers will already comply with the suggested standard. Preliminary research has suggested that some service providers will not – which indicates that they are acting contrary to market practice. However, if such a standard is agreed by the main industry players, market forces may force the other product providers to comply with the standard. This would be in the interests of consumers.[9]

The success of the implementation of decided standards depends on financial institutions. These institutions have to be fair, clear and not misleading. The wide-spread adoption of decided standards will be a very important support for establishing these standards.

Islamic financial institutions, consumers and their partners should prepare some consultation papers so that the implementation of standards will be easier. If there is a sufficient support then these standards can be settled by institutions and partners. The success is based on the responses to the consultation papers.

To promote the acceptance of the standards, it can be entered into informal associations with public organizations. A logo can be used so that Islamic financial institutions can assert compliance with the standards. Press conferences, media briefings can be organized. A website which is a bespoke can be created for the standards and in this website Islamic financial institutions that comply with the standards can be mentioned with a brief profile and a link to their website.

Islamic financial institutions, consumers and partners have to answer some questions.

(a) Would there be support for the creation of an independent institution which can decide the standards, follow the process of the implementation of the standards, check Islamic financial institutions that comply with the standards, and feedback both partners and consumers?

(b) Who will be included in that independent institution?

(c) Should there be disclosures for the institutions that do not comply with the standards?

(d) Would product providers be amenable to the partners taking steps to verify compliance with the standards?

Asymmetric Information

Asymmetric information is an information that differs between parties to transaction situation in which consumers, suppliers, and producers do not all have the same information on which to base their decisions.[10]

Since in Islamic finance profit and loss are shared it motivates to assess risks more carefully and monitor the use of the funds by borrowers. Because of this reason, Islamic financial institutions, consumers and partners should be interested in the outcome of the underlying transaction. Norashikin Mohd Kassim says "One of the most important lessons to be learnt from the present crisis is that the financial sector became too removed from the real world economy.

Asymmetric information should be provided by only Islamic institutions and partners to consumers. Consumers should act according to supplied information when doing the business. Consumers should decide the investments. Partners will give help consumers to decide the investments. Islamic financial institutions have to inform consumers about the investments and supply documents and give opportunity consumers to see profit or loss. Consumers should decide several type of different investments with different percentage. According to Mohsin Khan(2000), the Islamic banks have to develop a contract to keep the monitoring costs for projects at a reasonable level and eliminate the moral hazards, a concept that originated in the insurance industry, issues arising when the lender and the investors have asymmetric information on the profits from the investment. In Islamic finance the major funds are obtained from the short-term mark-up deals. The limitation of financial instruments is

the main problem of Islamic finance. Mark-up deals are low risk investments instruments so since there is no real profit or loss sharing system in Islamic finance nowadays mark-up deals are used very commonly.

Conclusion

Islamic finance has actually many financial instruments but because of imitation of conventional finance it is being seen that Islamic finance is a system that has only with limited instruments. Islamic finance depends on main principle of profit and loss sharing (PLS) system between two parties' investors and financiers. At the end of decided periods, an Islamic bank has to share its profit with its clients who accepted risks of investments. Establishing real profit or loss sharing system will bring many different alternatives for financial institutions and depositors/savers. Transparency and asymmetric information are very important issues for sharing of risks. For the real profit-loss sharing system documentation must be supplied by institutions, there must be partners work with financial institutions and depositors/savers, for transparency standards must be decided, and institutions that comply with these standards must be certificated by independent institutions including public institutions. By using media and organizing conferences, symposiums, settling independent websites these standards can be wide-spread.

Notes

[1] Islamic Finance: An Ethical Alternative to Conventional Finance, (2008), Aziz Tayyebi

[2] Wikipedia.org

[3] Instrument of Islamic Finance and Banking Mohammed Ali Elgari, Mufti Taqi Usmani, Yusuf Talal Delorenzo, M. Umar Chapra

[4] Wikipedia.org

[5] Instrument of Islamic Finance and Banking Mohammed Ali Elgari, Mufti Taqi Usmani, Yusuf Talal Delorenzo, M. Umar Chapra

[6] Wikipedia.org

[7] Hand of Islamic Banking, (2007), M. Kabir Hassan and Mervyn K. Lewis

[8] Choong and Liu, 2006; Ainley and others, 2007

[9] Business & Economics Committee, The Muslim Council of Britain, (6 October 2008)

[10] www.qfinance.com/dictionary/asymmetric-information

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