RISK: IDENTIFICATION AND MANAGEMENT IN ISLAMIC MODES OF FINANCE

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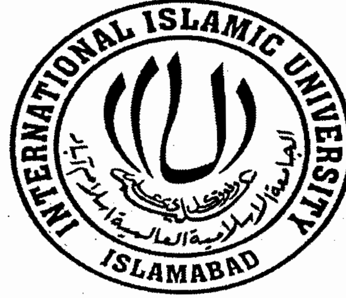

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ISLAMABD

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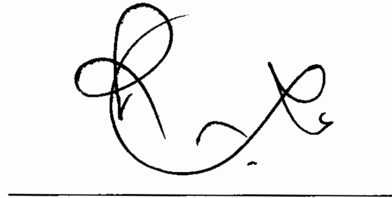

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LIST OF ABBRIVIATIONS

AAOIFI: Accounting & Auditing Organization for Islamic Financial Institutions

BCBS : Basel Committee for Banking Supervision

CAMELS: Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to risk

IFIs: Islamic Financial Institutions

IAIB: International Association of Islamic Banks

IASC: International Accounting Standards Committee

IASs: International Accounting Standards

IDB: Islamic Development Bank

IMA: Internal Management Approach

IRB: Internal Rating Based

IRTI: Islamic Research and Training Institute

LIBOR: London Inter-bank Offered Rate

LLR: Lender of Last Resort

MCM: *Murabahah* Clearing Market

M-M: Mudarabah – Musharakah

MOF: Maturity of Facility

OECD: Organization for Economic Co-operation and Development

OIC: Organization of Islamic Conference

PLS: Profit-and-Loss Sharing

SA: Standard Approach

VaR: Value at Risk

Dedication

I dedicate with gratitude and affection this peace of work after the grate educator Holy Prophet Muhammad (S.W.A) to my Sweet Father may Allah shower His blessing on her soul.

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Abstract:

The need for risk management is an every day business. The success and failure of every business is largely affected by the ability to manage the risks associated with it and to minimize them as much as possible. A wide range of instruments have been designed in the conventional system of finance to address the issue. The need for risk management in Islamic modes of finance is not an exception. However, due to its own structure and objectives, the Islamic system of finance may reject some of these tools of risk management due to their involvement in *riba, gharar* or excessive speculation. However this will not stand in the way of the formulation of islamically acceptable instruments for risk management. Therefore we have to develop our own theory that deals with unique concept of risk from an Islamic perspective to establish banks that are *Shariah* compliant, enjoy depositors' confidence and are efficient and stable.

IMPORTANCE OF THE TOPIC

The concept of risk was well known in ancient societies. Even in financial decisions, people knew very well that lending to someone who is bankrupt has a high probability of losing the money as compared to a debtor with good standing. Nevertheless, risk became an important tool of decision-making when it became possible to measure it and to assign values to different situations. In the past theoretical studies on Islamic banking have focused on Islamic modes of financing and their ability to perform financial intermediation for catering to the needs of people so as to be substitutes for loans while ensuring the compatibility of these modes with laws regulating banking operations. Banking supervision, however, has not received its due share in these studies. It is well known that banking supervision is concerned with various aspects of risks in banking operation. As the bank is a trustee of public funds, it is incumbent upon it to utilize these funds in ways that protect the rights of the owners of these funds. Therefore, comparative studies on risk underlying Islamic modes of finance are extremely important. They promote a sound understanding of various aspects of Islamic banking operations, an understanding that is need by supervision, institution likewise they encounter an objection that Islamic modes of finance carry much higher risks than interest based loans.

The rapid expansion and growth of Islamic banking and finance is clear indication of the viability of the system and its ability to face the modern challenges of business. The issue of risk management in Islamic modes of finance is one of the problems that need to be addressed by Muslim jurists and economist in order to maintain the competitiveness of the Islamic financial system. A range of tools already in use in the conventional system of finance to manage such risks but some of these tools are not acceptable in these modes due to their Islamic nature. Therefore, design of an islamically acceptable formula is must to manage these risks.

METHODOLOGY

The study is built upon existing literature, both classic fiqhi literature and modern work on Islamic Banking and Finance. The focus of the thesis is on the actual practice of Islamic banks. Therefore, the Qualitative method of writing will be followed instead of quantitative.

A distinction between theoretical formulations and actual practices of Islamic banking can be observed. Theoretically, it has been an aspiration of Islamic economists that on the liability side, Islamic banks shall have only investment deposits. On the asset side, these funds would be channeled through profit sharing contracts. Under such a system, any shock on the asset side shall be absorbed by the risk sharing nature of investment deposits. In this manner, Islamic banking offers a more stable alternative to the traditional banking system.

The practice of Islamic banking, however, is different from the theoretical aspirations. On the assets side, investments can be undertaken using profit sharing modes of financing (Mudaraba and Musharaka) and fixed-income modes of financing like Murabaha (cost-plus or mark-up sale), installment sale (medium/long term Murabaha), Istisna'/ Salam (object deferred sale or pre-paid sale) and Ijarah (leasing). The funds are provided only for such business activities which are Shariah compatible. On the liability side, deposits can be made either in current accounts or in investment accounts. The former is considered in Islamic banks as Qard hasan (interest-free loan) or Amanah (trust). These have to be fully returned to depositors on demand. Investment depositors are rewarded on the basis of profit and loss sharing (PLS) method and these deposits share the business risks of the banking operations. Using profit sharing principle to reward depositors is a unique feature of Islamic banks. This feature along with the different modes of financing and the Shariah compliant set of business activities change the nature of risks that Islamic banks face.

In order to achieve the desired goals, to access to the hypotheses of the study and to identify and manage risks faced by Islamic modes of Finance a descriptive analytical approach is adopted that will shed light on the aspects of the subject as a new revolution in Islamic banking industry. After exploring the results and analysis, efforts have been made for an appropriate frame work confers to the requirement of Shariah.

Translation used for the versus of the Holy Quran is by Abdullah Yousaf Ali, electronic version available on http.//www.uah.edu/msa/quranyousafali/html

LITERATURE REVIEW

Fiqh al-Muamalt is an important branch of Islamic Law which regulates commercial relations among the member of Muslim society. The classical jurists have paid grate attention to this field by dealing special chapters in their books on partnership contracts, sale, hiring, mortgage, assignment of debt, and many other commercial contracts. They discussed at great length the principal underlying these contracts. The aim of all these exercise is to enable a Muslim individual to practise the Islam teaching in his economic life and observe Halal and Haram in al his commercial activities.

Today there is an earnest desire and persistent demand on the part of the Muislim Ummah for return to Islamic system and Islamic Law, in repose to this demand many Muslim countries are engaged in bringing their system, specially banking industry, in conformity with the ideals and value system of Islam .the supreme Court of Pakistan declared all forms of interest un-Islamic in the country. It has also declared null and void all these banking laws which are repugnant to the injunction of Shariah. This judgement is a great step towards Islamization of commercial laws of the country.

No book explains fully risk identification and management system of the Islamic modes of investment, but there are some books which cover the matter in issue to some extent, some are as follows:

Al-Sharikat fi al- Fiqh al-Islami, Ali al-Khafif, maktabah tawfiqiyyah cairo.

Al-Muwafaqat, Al-Shatibi A.I, S.A. Diraz.

Al-Mughni,Ibn-Qudamah, Cairo.Dar al-fikr

Al-Mudawwanat-ul-kubra Imam-e-Malik, Beirut, Darulfekar.

Al-Mabsaut Sarakhsi, Abubakar Muhammad Ibn Ahmad, Matba ‘ah Tarbin, Damascus.

Nayal Al-Awtar, Shawkani (1372 A.H.), Matba`ah Mustafa al-halabi, Cairo.

Al-Madkhal al-Fiqhi al-Am Zarqa, Mustafa Ahmad, Matba 'ah Tarbin, Damascus.

Al-Fiqh al-Islami wa addillatuhu Zuuhayli,Wahba Zuhaili, ,Damascus.

Inayah ala- Fath-Al-Qadir Babarty, Cairo:Dar al-Afaqaq al-jadidah.

Contemporary Practices of Islamic Financing Techniques Ausaf, Ahmad Dr., IRTI, Jedda Saudi Arabia.

The Permissible Gharar (Risk) in Classical Islamic Jurisprudence, Al-Saati Abdul-Rahim.

Regulation and Supervision of Islamic Banks, Chapra, M. Umer and Khan, Tariqullah, Jeddah: IRTI-IDB,Jeddah.

As the Islamic bank is the trustee of public funds it is incumbent upon it to utilize theses funds in ways that protect the rights of the owners of these funds to build their confidence on Islamic banking, although the risk can not be eliminated totally but it can be minimize through different techniques explained in this study.

INTRODUCTION

Islamic banking system was introduced as an alternative to conventional banking system mainly to provide Shariah compliant investment, financing, and trading opportunities. During its short history, the growth in the nascent banking industry has been impressive. One of the main functions of financial institutions is to efficiently manage risks that arise in Islamic modes of finance. To provide financial services at low risk, conventional financial institutions have developed different contracts, processes, instruments, and institutions to mitigate risks. However, due to its own structure and objective, the Islamic system of finance may reject some of these tools of risk management due to their involvement in *Riba, gharar* or excessive speculation. However this will not stand in the way of the formulation of islamically acceptable instruments for risk management. Therefore we have to develop our own theory that deals with unique concept of risk from an Islamic perspective to establish banks that are Shariah compliant, enjoy depositors' confidence and are efficient and stable. So, the future of the Islamic financial industry will depend to a large extent on how these institutions will manage different risks arising in Islamic modes of finance.

A distinction between theoretical formulations and actual practices of Islamic banking can be observed. Theoretically, it has been an aspiration of Islamic economists that on the liability side, Islamic banks shall have only investment deposits. On the asset side, these funds would be channeled through profit sharing contracts. Under such a system, any shock on the asset side shall be absorbed by the risk sharing nature of investment deposits. In this manner, Islamic banking offers a more stable alternative to the traditional banking system.

The focus of this study is on the actual practices of Islamic banks especially on the investment side to identify, measure, and manage different risks arising while using Islamic financing techniques. The practice of Islamic banking, however, is different from the theoretical aspirations. On the assets side, investments can be undertaken using profit sharing

modes of financing (*Mudaraba and Musharaka*) and fixed-income modes of financing like *Murabaha* (cost-plus or mark-up sale), installment sale (medium/long term *Murabaha), Istisna'/ Salam* (object deferred sale or pre-paid sale) and *Ijarah* (leasing). The funds are provided only for such business activities which are Shariah compatible. On the liability side, deposits can be made either in current accounts or in investment accounts. The former is considered in Islamic banks as *Qard hasan* (interest-free loan) or *Amanah* (trust). These have to be fully returned to depositors on demand. Investment depositors are rewarded on the basis of profit and loss sharing (PLS) method and these deposits share the business risks of the banking operations. Using profit sharing principle to reward depositors is a unique feature of Islamic banks. This feature along with the different modes of financing and the Shariah compliant set of business activities change the nature of risks that Islamic banks face.

While Islamic banks being commercial enterprises would be more concerned with growth of assets and profitability, regulators would prefer the banks to be more stable and have growth as secondary concern. Due to the unprecedented developments in the areas of computing, information and mathematical finance, the financial services markets have become extremely complex. Moreover, cross-segment mergers, acquisitions, and financial consolidation have blurred the risks of various segments of the industry.

Given this complexity, dynamism, and transformation in the financial sector there are several questions that can be raised related to Islamic banks. How do the Islamic banks perceive their own risks and these various developments? How regulators expect to respond to the new risks inherent in Islamic banks? What possible Shariah compatible risk management instruments are available at the present? What are the prospects of exploring new instruments in the future? What are the implications of all these for the competitiveness of Islamic banks? How is stability of the Islamic financial institutions going to be affected? The objective of the

present paper is to address some of these questions. Specifically the paper aims at the following:

i. Explaining the concept of risk, *gharar* (uncertainty) in Islamic Law.

ii. Presenting practical overview of the major Islamic modes of financing, and the nature of risks involved in each of these modes, after identification of these risks, the concepts of risks management techniques and standards in each of these modes are explained.

iii. Discussing the unique nature of country party risks of the Islamic financing techniques and the perceptions of Islamic banks about these risks.

iv. After identification of these risks, the concepts of risks management techniques and standards in each of these modes are explained.

v. Reviewing the main regulatory concerns with respect to risks and their treatment with a view to draw some lessons for Islamic banks.

vi. Discussing and analyzing the Shariah related challenges concerning risk management in the Islamic financial services industry and

vii. Presenting policy implications for developing a risk management culture in Islamic banks.

viii. At the end some suggestions and recommendations have been given to develop risk management cultural in Islamic banks to survive in future and compete with conventional system.

CHAPTER NO. 1

I. RISK FROM AN ISLAMIC PERSPECTIVE

1.1. Literal meaning of the word "Risk"

The term risk (Italian: risco, French: risque) is derived from the Latin roots re = back and secare = cut, thus reflecting the potential for a sailor to have his ship cut by hitting a rock. In other words, "risk" means "danger of loss" or "the chance or possibility of suffering loss, damage, injury etc".[1]

1.2. Technical meaning of the word "Risk"

The word "Risk" hardly needs a definition. Its meaning is evident and is almost the same as understood by people in every day conversation. If one were to say, "there is risk in a certain thing" the person listening would understand that he is talking about a situation where there is uncertainty as to the occurrence of desired result and the probability that the consequence would be something that is not desirable. This is exactly what is meant by risk as used in financial literature. It refers to a situation in which two or more outcomes are possible. It is evident that circumstances in which there is possibility of only one outcome are circumstances that bear no risk[2]

Risk is defined by Emmet J. as "the situation that involves the probability of deviation from the path that leads to the expected or usual result".[3] Another writer states that in simple term it means "the likelihood of loss".[4] As per web definition "Risk is the probability or threat of damage, injury, liability, loss, or other negative occurrence, caused by external or internal vulnerabilities, and which

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[1] M. Robinson,G. Davidson, *Chamber 21st Century Dictionary*, 2nd edition, Cambridge University Press.

[2] See Muhammad Ali Elgari, *Credit Risk in Islamic Banking and Finance*, Islamic Economics studies, vol.10, no.2, March 2003, p.12.

[3] Vaughan, Emmat J, *Fundamental of Risk and Insurance* (1991), New York, John Wiley & Sons, p. 7.

[4] Megginson,William L (1997) Corporate Finance Theory: Reading, Mass: Addition-Wesley, p. 95.

may be neutralized through pre-mediated action".[5] Risk is present in all acts undertaken by human beings; but it acquires special significance when the study is of risk as an ingredient of the process of arriving at financial decision.

According to Mustafa Al-Zarqa a good translation of Gharar is "Risk" or "Uncertainity" he defined it as "*Gharar* is the sale of probable items whose existence or characteristics are not certain, due to risky nature which makes the trade similar to gambling".[6] The literal meaning of the term *Gharar* according to Qadi Iyad (c.f. Al-Qarafi,) is: "that which has a pleasant appearance and hated essence".[7]

Risk is studied as a subject within several social sciences. These include statistic, economics, financial management and insurance. Examination of risk in each of these sciences has specific aspects that differ from those in others. Despite the intricacies that surround the discussions of risk, its meaning does not go beyond what has been stated above.[8]

1.3 The Meaning of *Khatar* in the terminology of Jurists:

The earlier jurists have been used the word *Khatar* in the meaning similar to that of risk. According to Al-Faumi "The meaning of Khatar vacillates between existence and non-existence"[9] *Khatar* also means the prize that is assigned for those participating in a wager. AL-Zamakhshari says in *AL-Fa'iq* that is the prize set aside for the winner.[10]

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[5] www.businessdictionary.com/definition/risk.html dt.12.10.09
[6] Zarqa, Mustafa Ahmad, *Al-Madkhal al-Fiqhi al-Am,* Matba 'ah Tarbin, Damascus, 1968, vol.3, p.356.
[7] Al-Qarafi, n.d, *AL-fur uq*. Beirut: Alam Al-Kutub,vol.3, p.266.
[8] See Muhammad Ali Elgari, *Credit Risk in Islamic Banking and Finance*, Islamic Economics Studies, vol.10, No.2, March 2003, p.12.
[9] Al-Fayumi, A.M.M. (n.d.), *Al-Misbah Al-Munir*, Beirut, Dar al-Afaq al-jadidah, p. 495.
[10] Al-Zamakhshari, al-Fa`iq, (1364HA) Cairo,Dar-al-Fikr, vol.1, p.332

A Western writer Ansell have expressed a unique opinion that the word risk has come into the English language from Arabic because the origin of the word is the Arabic word *rizq*. They argue that whatever profit or loss is made by a Muslim is viewed as (sustenance) coming from God, and he is satisfied with it[11]. The word has, however, acquired a new meaning in modern Arabic where it is now equivalent to the English word "Risk"[12]

The word became a new technical term in the discipline of finance. It is for this reason that we do not find the word used in the works of the earlier jurists in this meaning. This does not mean that the well-known risks, like the risk of fluctuating prices, credit risk, and risk of loss faced by investments, were not prevalent in early financial and trade transactions. Risk exists in every contract that matures in future, and there is no doubt that this was known to them. It is for this reason that they permitted contracts of *sharikah* (partnership), *mudarabah, Salam* and so on, as each of these contracts involves a transfer of sharing of risk. However, the economic circumstances prevailing in those days and the methodology adopted for contracts did not attach the significance to the idea that is given to it in modern financial transactions. Perhaps, the reason for this is that no methods for measuring risk were available to earlier jurists. It is well known that the significance of studying risk emerged only after the development of methods for measuring risk, and it was this that enabled the classification of contract according to the degree of inherent risk and the inclusion of measures of risk in the process of decision-making.[13]

1.3.1 *Khatar* in Fiqh, arises from the *Sighah* (form) of the contract

Khatar in Fiqh is related to the contract. It refers to uncertainty that is generated by the contractual relationship. It arises from the *Sighah (form)* of the Contract. In Islamic Shariah, it is necessary that

[11] See Ansel, Jak and Frank Wharton (1992),*Rrisk Analysis, Assessment and Management*, London:jon Wily & Sons, p.7
[12] See Muhammad Ali Elgari,*Credit Risk in Islamic Banking and Finance*, Islamic Economics Studies,vol.10,No.2, March 2003, p.11.
[13] Ibid

the contracts spell out clearly the rights and obligations arising from them. If they involve ambiguity or lack of clarity, they are deemed risk-bearing contracts without reference to the external circumstances surrounding the parties. These factors do not affect the meaning of *khater* in Fiqh.

All this is known in books of Fiqh. We quote below statements of Malik from *al-Mudawwanah* in which he compares the tow types of contractual relationships. The first he describes as risky and the second not risky, although both carry the same meaning of risk in financial literature.

Malik said, about a person buying goods from another on the assurance that there would be no loss for the buyer, that this sale is not permitted.

Malik said that if a person buys goods from another and the sale is executed, but then the buyer regrets it and asks the seller to reduce the price, and the seller refuses to do so and asks him to sell it back without loss to him, there is nothing wrong with this sale as it does not belong to the category of *Mukhatarah*. It is something that he chesses himself and their contract of sale was not based on this.[14]

This explains that *khatar* in the terminology of jurists is an attribute for a type of contract whose form implies rights and obligations that are "probable" for both sides. Risk within the meaning of financial literature is linked to forces that govern the ultimate outcome of the contract. The difference between the first and second case mentioned above is only legalistic. Financially, they are the same.[15]

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[14] Malik,Imam-e-Malik *Al-Mudawwanat-ul-kubra*, (1412 A.H.) Dar al-Fikr Vol.4.p.49

[15] See Muhammad Ali Elgari, *Credit Risk in Islamic Banking and Finance,* Islamic Economics Studies,vol.10,No.2, March 2003, p.12.

We have seen that risk in the financial sense consists of those forces that lead to a deviation from the expected path of outcomes arising from contractual relationship. These forces do not have a direct bearing on the form of the contract. Rather, they relate to the circumstances surrounding the contractual relationship that arises from the contract, like a change in economic climate or adverse circumstances faced by one of the parties and so on. On the basis of this reasoning, it is not possible for us to generalize and say that if a bank advances a loan to a customer then this, by necessity, carries a lower risk than the bank giving the same amount on the basis of participation. The reason is that a loan advanced to one with meager resources bears a greater risk than a partnership with a wealthy and trustworthy person who is able to generate profits. This is the meaning of risk in financial studies.[16]

1.4. The Basis of Risk

Although this meaning of *khatar* does not have a place in the works of the earlier jurists, yet we often find researchers in Islamic banking arguing on the basis of qawaid *fiqhiyyah* that a relationship of direct proportion between risk and return is well known in Islamic law. Among these are principles emerging from the traditions of the Holy Prophet (peace be upon him), "*algunmu bil ghurm*" (profit is linked to loss) or "*al-khiraj bid-daman*" (Entitlement to revenue is based on corresponding liability for bearing loss) and " *ribh ma lam yadman*"(taking of profit without liability). Along with these is the prohibition from the Prophet (peace be upon him) of earning profit without a liability and of transactions involving *gharar* (hazard). On the basis of all this, jurists maintained (for example) that the owner of capital is entitled to profit in a *Murabaha* contract for he bears some risk, and that the lender in a loan contract is prevented from taking an excess or reward as he does not bear any risk. Further, the prohibition from the Prophet (peace be upon him) of

[16] Ibid

earning profit without a liability for loss is evidence that profit is not lawful without the liability for bearing risk, and so on.[17]

1.4.1. *"Al-Kharaj Bid -Daman* **and"***Ribh Ma Lam Yadman"*

The word *Daman*, in the terminology of jurists, has several meaning. The Shafi, Maliki and Hanbali jurists employ the word *Daman* in the meaning of surety (*kafala*) in the sense of fulfilling one's obligation towards other.[18] The Hanafis use the term *Daman* in the meaning of obligation to compensate in financial terms for an injury caused to another.[19] The majority of jurists, however, employ the term in the sense of bearing the burden of destruction of the goods soled, and they deem it a condition for the validity of the sale after purchase.[20] Likewise, the purpose of possession, according to the majority, is the transfer of *Daman* (liability) that is the liability for bearing the loss due to destruction, from the seller to the buyer.[21] It is for this reason that a sale with an undetermined subject matter (such as buying a sheep from a flock of 100) is not permitted lest ownership be transferred to the buyer through offer and acceptance and the liability stay with the seller. If the buyer sells it and makes a profit, he will not be entitled to the profit. This is because he did not bear the liability and thus the sale was not valid. The jurists rely in this on what is stated in the traditions of the Holy Prophet (SWA): "*al-kharaj bid- daman*" (entitlement to revenue is based on corresponding liability for bearing loss) and the tradition prohibiting *"ribh ma lam yadman"(*taking of profit without liability).

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[17] See Muhammad Ali Elgari, *Credit Risk in Islamic Banking and Finance,* Islamic Economics Studies, vol.10, No.2, March 2003, p.12.

[18] See Ibn-Qudamah, *al-Mughni, (*1412 H.A) Cairo,Dar al-Fikr, vol.7, p.418.

[19] See Shiribini, *Mughni al –Muhtaj,*Shrikah wa-Matba`ah Mustafa al-Baji al-Halabi,Cairo,vol.2, p.22)

[20] See Ibn-Qudamah, *al-Mughni*, (1412 H.A) Dar al-Fikr, Cairo,Vol.7, p.420

[21] See Ibid

Al-Shafi, Ahmad, the compliers of the sunan and al-Hakim have recorded by way of Urwah from Aishah that a man purchased a slave during the time of the Messenger of Allah (peace be upon him) and he remained with him for some time according to the will of God. Thereafter, he returned him on the basis of defect that he found. The Messenger of Allah (peace be upon him) judged in favor of his return on the basis of defect. The person against whom the decision was given said, "but he benefited from him." The Messenger of Allah (peace be upon him) replied: "*al-kharaj bid-daman*."[22]

The jurists have disagreed about the chain of transaction of this tradition as well as its legal content. Ibn al-Qatlan declared the tradition to be sound as is stated by al-Hafiz Ibn Hajar[23]. Al-Zarkashi said that the tradition is sound, while Ibn-Hazam said that the tradition is not sound[24] It is stated in al-Qabas ala Muwatta Ibn Anas, "*al- kharaj bid-daman* is a tradition that is not sound."[25]

Those who uphold this principle argue for it on the basis of the saying of the messenger of Allah (peace be upon him), "Sell not what you do not have."[26]. They also rely on the saying of the messenger of Allah (peace be upon him), "A loan with a sale is not permitted, nor two conditions in a sale nor a profit of a thing allowed which is not in one's liability, nor the sale of what you do not have in your possession".[27]

The jurists argue on the basis of these two traditions that he growth (usufruct) of the sold thing belongs to the buyer. Its liability is, therefore, upon him. They also reason within the topic of return due to defects as follows: Abu Hanifah, Malik and Al- Shafi said, "Entitlement to revenue is linked to liability for bearing loss." Again within the issue of the benefit of an usurped asset, Ibn- Qudama

[22] Abu Dawud, *Sunan*, H. no.3508,vol.3,p.777
[23] Hafiz Ibn Hajar , *Al- Talkhis al-Habir* (1372 A.H) Almaktaba-Al-atharia Sangla Hill Pak. vol 2, p 345
[24] Ibn Hazm Ali, (n.d.), *Al-Muhalla,* Beirut, Dar Al-Aafak Al-Hadiyra.p.321
[25] Al-Qabas *al-Muwatta* Malik Ibn Anas Li Ibn 'Araby,(1992)Darul Garb-Al-Islami vol.3, p.324
[26] (Abu Dawud, Sunan, H. no.3530)
[27] Abu Abd al-Rahman ibn Shuayb Nasai, *Sunan*,Istanbul: Dar al Dawah, Kitab al-Tijarah,H. no.4625,4644,vol.7,p.33

says, "Those who do not impose compensation (by way of damages) argue on the basis of the words of the prophet (peace be upon him), " *al-kharaj bid-daman*, and its liability is placed on the usurper."[28] On the basis of this reasoning, compensation is not awarded because he bears the liability during his possession.

Scholars disagreed about the jurisprudence of this tradition. Some of them considered it a fundamental principle in contracts. They therefore did not uphold the traditions that opposed this principle. Thus, we find that Abu Hanifah did not accept the tradition of *musarrat*[29] as it conflicted with one of his accepted principles and it is a textual principle being a saying of the Prophet (peace be upon him): *al-kharaj bid daman.*[30] The reason for not accepting the tradition *of musarrat* is the buyer bears the liability of this goat in case it dies in his possession. The milk is the usufruct and it belongs to him in lieu of the liability. If he returns the goat to the buyer, he is not liable for anything.

The Hanafis, likewise, did not accept the tradition about discount due to calamities (in case of sale of fruit on trees), because it goes against the fundamental principle in their view, that is, *al-kharaj bid Daman.* They also said a Mudarib (worker) is not permitted to extend the money of Mudarabah ownered to someone else on a mudaraba contract, as this, in their view, is earning of profit without *daman.* Likewise is the contract of sub-letting by a tenant for he is earning a profit from something for which the liability is born by the person who rented out the property initially.[31] The Malikis adopted the other view despite the conflict with the principle of *al-kharaj bid Daman*, because the tradition of *mussarra*t is stronger in their view.

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[28] See Ibn-Qudamah, *al-Mughni, (*1412 H.A) Cairo,Dar al-Fikr,Vol.7, p.418.

[29] *Tasriyyah* is the tying up of the udder of a goat or camel till it bloats due to the milk collected in it. The owner then takes it to market and the buyer believes that it gives that much milk only to discover after a day or two that it was musarrat. A hadith says "Do not tie the udder of a camels and goats. He, who buys such an animal, has an option after he has milked it. If he likes he can keep it. if he dislikes it, he can return it along with a sa of dates" This Hadith is related by al-Bukhari and Muslim.

[30] See Kasani, *Badai al-Sana'i fi Tartib al- Shara`i, Sharikah al- Matbu`at al-Islamiyyah,* Cairo,vol.5,p.187

[31] See Shiribini, *Mughni al -Muhtaj*, Shrikah wa-Matba`ah Mustafa al-Baji al-Halabi,Cairo,vol.2, p.22)

Some jurists restricted the meaning of the tradition to food alone. Thus, Imam Ahmad as well as Ishaq Ibn Rahway was asked about profit without liability, and he said:

"In my view this applies only to food, that is, food items that have not been taken into possession, while Ishaq applied this to all that is sold by cubic measure and weight."[32]

It is possible to say *al-kharaj bid-daman* deals with a kind of risk that is inherent in all commutative contracts. This is the risk of destruction of the item prior to its possession by buyer. The lawgiver, therefore, determines that the profit to be derived in such transactions be linked with liability (that is bearing the liability of loss) Thus, if a person buys goods by description, the contract is valid and permits the passage of property, but in order for the profit to be realized for a third party by means of sale, it is necessary that possession be taken to let this rule operate. The taking of possession leads to transfer of the risk arising from the destruction of property from the original seller to the buyer and entitles him to profit. This conclusion, however, is not always applicable due to two reasons:

First: The linking of profit with liability for loss is a matter on which jurists have disagreements. Some of them as Imam Ahmad restricted it to food, and whatever is similar to it, while Ishaq Ibn Rahway linked it to things sold by measure and weight. There is no doubt that the tradition of *musarrat* and that for reducing the price on account of calamities indicate that the *principle al-kharaj bid-daman* is not a general principle or a principle that cannot be violated.

Second: That the meaning of *al-kharaj bid –daman* and the prohibition of profit without liability have meanings different from the meaning of risk in financial transactions. Risk in financial transactions relates to taking decisions under uncertainty. Just as the parties to a contract face risks arising from the relationship created by the contract between them, there are many other risks that an

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[32] Ibid

individual faces. The principle *al- kharaj bid-daman* is rule for ensuring justice in relationships between people arising from commutative contracts, while the concept of risk is wider than this and more general. From another aspect, the direct relationship between profit and risk is an established proposition in all-financial decisions. As for *al-kharaj bid-daman*, it is legal text that determines the rights of the parties to specific financial dealings and is related to the liability arising from destruction that may affect the goods that are the subject matter of a contract. Those who uphold this principle have linked the entitlement to profit with the bearing of this liability so that no injustice is caused to one party by the other party.

1.5 Relationship between Risk, Uncertainity and *Gharar*

In this section Risk, uncertainty and *gharar* can be defined to narrow the gap between Conventional definition of risk, uncertainty, and the Shariah definition of *gharar* which might help to understand the nature of *gharar* in new transaction, before any judgment on transactions can be made.

Risk is taken to be a measure of uncertainty about the frequency and consequences of an unacceptable event or, the probability of an undesired outcome expressed in money terms.[33]

According to Knight (1921), "[a] situation is said to involve risk if the randomness facing an economic agent can be expressed in term of specific numerical probabilities (these probabilities may either be objectively specified as with lottery tickets, or else reflect the individual's own subjective beliefs) while, uncertainty situations arise when the agent cannot (or does not) assign actual probabilities to the alternative possible occurrences.[34]

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[33] Chicken, C. J., (1966), Risk Hand Book, International Thomson Business Press, p. 1.
[34] Knight, F.H. (1921), Risk, Uncertainty and Profit, Chicago: University of Chicago Press: Basta: Houghton Mifflin 1971.

The Economist, dictionary of economics define risk "A state in which the number of possible future events exceeds the number of events that will actually occur, and some measure of probability can be attached to them. This definition distinguished risk from uncertainty in which the probable are un-known.[35]

In many studies risk is used to mean uncertainty, so risk is defined to be 'the possibility that adverse consequences might occur'. Exposure to risk is the condition of being unprotected against the possibility that adverse consequences might accrue. However different interpretations of an adverse consequence can be found, as some enterprises consider loss to be adverse consequence while others may consider fluctuation in income, prices, interest rate, foreign exchange, or cash flow to be adverse consequences.[36]

Risk is the probability of happening of an event whose occurrence is uncertain. As such events that are certain do not involve any risk. It is uncertainty that breeds risk. The likelihood of loss in trade is risk. When it does happen however, it is not reckoned as risk, but as something that becomes certain. A fall in the market value assets is risk, but a decline in the value of an asset as a result of consumption (as a result of utilization or passage of time) is not a risk, because it is something that is certain to happen. Return on an investment is directly related to its riskiness. People are prepared to bear higher risks if these are accompanied by the probability of compensatory returns. The investor is concerned with measuring risk so that he does not bear a higher risk in lieu of low returns. It is for this reason that people need measures of risk. Frank Knight in the early part of this century explained the difference between the meaning of risk and uncertainty in the economic sense. Risk is something in which the measuring of probabilities and the occurrence of undesirable events

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[35] Graham B and Evan Davis, *The Economist- Dictionary of economics*,Profile Book Ltd,London.

[36] Adams, J. B. and Mouteri, C. J. (1995), *Major Issues Relating Hedge Account,* Financial Accounting Series, October, No. 154-B.

is possible, but uncertainty is a situation when measuring of probabilities is either not possible or is not beneficial.[37]

The Muslim jurist's perception and implication of risk and uncertainty is not far from those of economists. Economists recognize risk as a measure of uncertainty about the frequency and consequences of unacceptable or unpleasant events. The uncertainty arises when an agent cannot assign actual probabilities to the possible alternative occurrences to the unacceptable or unpleasant event. Their objective is to model these uncertainties and to find the optimal behavior of the economic agent facing uncertainty.[38]

Islamic jurisprudent recognizes *Gharar* which is a kind of uncertainty and one of the major causes of the invalidity of a contract, it is an external prohibited attribute that invalidate the contract. Literally Gharar means uncertainty, risk or hazard. *Taghreer* being the verbal noun of gharar, it means, deception or misrepresentation, which includes exposing oneself or others or his own property or others to jeopardy[39]. It includes such elements as doubt, suspicion, uncertain conditions, the absolute lack of knowledge about and in determinability of the basic elements of the subject-matter. [40]

The Jurists' aim is to show that *Gharar* is one of the major Islamic constraints on transaction which renders some transactions as invalid and void.[41] Some jurists do permit some *Gharar* transaction if the *Gharar* is light or in the face of necessity for that transaction, given that this need is both general and specific and there is benefit (*Maslaha*) from the given transaction, which can be considered as

[37] See Knight, F.H. (1921), *Risk, Uncertainty and Profit,* Chicago: University of Chicago Press: Basta: Houghton Mifflin 1971.
[38] Abdul-Rahim Al-Saati, *The Permissible Gharar (Risk) in Classical Islamic Jurisprudence*, J.KAU: Islamic Econ.,□Vol. 16, No. 2, pp. 3-19 (1424 A.H / 2003 A.D)
[39] Mohammad Siddiq Darir, *al-Gharar fi al-Uqud wa Atharuhu fi al- Tatbiqat al-Muasirah,*IDB, Jeddah, p.10
[40] Muhammad Tahir Mansoori. *Islamic Law of Contract and Business Transaction*, Shariah Academy, IIUI, p.93.
[41] Abu Ishaq Shirazi, al-Muhaddab, Cairo:Dar al-Nasr vol.4, p.109

particularization of a general ruling (hukm) on the basis of stronger evidence which is either obvious or imbibed.[42]

1.5.1 In jurisprudential terms, *Gharar* has many definitions which can be summarized under three headings:

First: *Gharar* means doubtfulness or uncertainty as in the case of not knowing whether something will take place or not; this excludes the unknown. Ibn Abidin defines *Gharar* as 'uncertainty over the existence of the subject matter of sale'[43]. This definition is shared by *Hanafi* and *Shafi'i* Schools.

Second: *Gharar* also means ignorance and this can be when the subject matter of sale is unknown. This view is adopted by the *Zahiri* School alone. According to Ibn Hazm "*Gharar* in sale occurs when the purchaser does not know what he has bought and the seller does not know what he has sold"[44].

Third: *Gharar* means both the unknown and the doubtful. According to Al-Sarakhsi "*Gharar* obtains where consequences are concealed"[45]. This view is shared by most jurists.

1.5.2 Muslim Jurists disagree on the degree of uncertainty in a transaction to be considered *Gharar* transaction: the probability of undesired outcome is envisaged into three classes.

First: *Gharar* occurs when consequences are totally concealed, which means the probability takes the value between zero to one. This can be understood from the definition of *Gharar* by Al-Sarakhsi: "*Gharar* obtains when consequences are concealed" [46] and by Al-Babarti: "*Gharar*

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[42] Al-Shatibi, A.I., (n.d.), Al-Muwafaqat, ed., S.A. Diraz, IV, p. 208.
[43] Ibn Abidin, *Radd al-Muhtar*, (1252 A.H.)H.M.Saeed Company,educational press Karachi Vol 4, P.147.
[44] Ibn Hazm al Andalusi, (1351 A.H.), *Al-Muhalha*,Dar-al-Afaq al- Jadida Vol.8,p.343 and 389 .
[45] Al-Sarakhsi, (n.d.), *Al-Mabsaut*, (1398H.A.)Darul-Marifat-Litabaat-e-annasur,biruit Labnan Vol.13,P.194.
[46] Babarty (n.d.),*Inayah ala- Fath-Al-Qadir*, vol,5, p.192

obtains when the subject matter is unknown"[47]. Ibn Abidin maintains that "*Gharar* is uncertainty over the existence of the subject matter of sale", and Ibn Taymiyyah that "*Gharar* is the unknown consequences"[48].

Second: *Gharar* occurs when the probability of existence is equal to the probability of non-existence. According to Al-Kasani "*Gharar* is the risk where the probability of existence and the probability non-existence have the same value"[49]. In *Al-Bahr Al-Zakhkhar* it is noted that '*Gharar* is the oscillation between the occurrence and non occurrence neither of which can outweigh the other'[50]. According to *Al-Dusuqi*, '*Gharar* is the oscillation between two things of which one of them is the subject matter'[51].

Third: *Gharar* occurs when the non-existence of the subject matter outweigs its existence. According to Al-Ramli "*Gharar* occurs when there is a possibility of two things occuring, the more likely is the one you fear to occur"[52]. For *Al-Sharqawy* "*Gharar* is the oscillation between two matters, the most likely to occur is the one you fear to happen"[53]. So we cannot consider the degree of uncertainty or risk to distinguish between the prohibited and allowed *Gharar*.

1.5.3 Classification of *Gharar*

In real life *Gharar* like uncertainty cannot be avoided totally. Al-Shatibi says "to remove all *Gharar* from contracts is difficult to achieve, besides, it narrows the scope of transactions. Jurists agree that the *Gharar* which affects the contract, is the excessive *Gharar*, as it impairs the validity of the

[47] Ibn Abidin, Muhammad Amin bin Umar Abidin *Radd al- Mukhtar ala-Dory al-Mukhtar* (1252 A.H.), the Bulaq Edition,vol.4, p. 147.
[48] Ibn Taymiyyah (n.d.), *Majmu' Fatawa*,dare Alam-al kutub,al-Riaz Vol.3,P.275.
[49] Kasani,Badai al-Sana`i`fi Trtib al- Shara`I Cairo, Sharikah al- Matbu`at al- Islamiyyah, (1910),vol, 5,p. 263.
[50]Al-Hasani Anmad Ben Yehia (1350 A.H.), *Al-Bahr A-Zakhkhr*, Muassesat-al-Resala,Biruit,Vol.3,P.293.
[51] Al-Dusuqi (1230 A.H.), *Al-Sharh Al-Kabir*, Dar-al –Ahya-al-Kutub-al-Al-Arabia,Vol.3,P.49.
[52] Shamsuddin-Al-Ramli (1357 A.H.), *Nihayat Al-Muhtaj,Darulfekar,Vol.*3,P.392.
[53] *Tuhfat Al-Tullab* with Notation of Sharqawi, Cairo, Dar-al-Fikr, p. 29

contract while a slight *Gharar* has no impact at all.[54] With the absence of concept to measure *Gharar*, wide differences exist among jurists in classifying *Gharar* and its applications. There are some cases where Muslim jurists agreed to represent slight *Gharar* such as:

1- Selling a lined overcoat though its lining is not seen.

2- Selling a house though its foundations have not been seen.

3- Renting a house for month, where the month can be thirty days or thirty one.

And there are some agreed upon cases to represent excessive *Gharar* such as:

1. The "pebble", "touch" and "toss" sale.

2. Selling the unborn animal without its mother.

3. Selling fetuses and embryos.

4. Selling an unborn animal (*Habal-al-Habalah*).

5. Selling the find of the diver in advance.

6. Selling an object of unknown genus.

7. Deferment of price to an unknown future date.

But there are wide differences among jurists in the intermediate cases where *Gharar* oscillates between being excessive and slight, and its effects on the contract is disputed and this disputed *Gharar* is more than the *Gharar* where effects is agreed upon, such cases as:

1. Selling what is hidden in the ground.

2. Selling in lump sum.

3. Selling at 'market price' without specifying the exact amount.

4. The buyer selling the object bought before he receives it.

5. Selling products that mature in successive phases.

6. Selling an absent object.

7. Share cropping.[55]

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[54] Al-Shatibi, A.I., (n.d.), Al-Muwafaqat, ed., S.A. Diraz, IV, p. 208.

Some jurists try to lay down a rule for excessive and for slight *Gharar*. According to Al-Baji, the slight *Gharar* is that (from which hardly a contract is free while excessive *Gharar* is that which dominates the contract that it comes to characterize it)[56]. But the characterization of contract as "*Gharar* Contract" is subjective and inevitably influenced by differences in technology, time, societies, and individual taste and preferences.

In terms of degree of permissibility of *Gharar* in Islamic transactions, *Gharar* can be classified into the following types:

First: The Prohibited *Gharar*:

This is the gambling type of *Gharar* which includes the idea of voluntary and deliberate *Gharar* taking, also involving sterile transfer of money or good between individuals, with no value added or created from the transaction. Ibn Taymiyah and Ibn Al-Qayyim consider exorbitant *Gharar* a type of gambling. According to them "*Gharar* obtains where consequences are concealed, selling with excessive *Gharar* is *Maysir* which is gambling: that if camel or horse lost, its owner can sell it with a very high risk and very low price, so if buyer finds it, the seller will tell him, you deceived me and bought it with very low price, but if he could not find it, the buyer would complain that he paid and got nothing in exchange. This will result in enmity and hatred between them. Exorbitant *Gharar* sale is vanity and injustice and causes enmity and hatred in society.[57] Examples of this typical *Gharar* are pebble, touch and toss sales. Authentic hadiths have been reported forbidding these types of sales. The majority of jurists are in agreement that the common reason for prohibition of all these types of sale is the fact that they involve exorbitant *Gharar*.

The pre-Islamic society had known contracts which were laden with excessive *Gharar*, but Islam came to specifically forbid them because the exorbitant *Gharar* in them impaired their validity of them. These are:

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[55] Abdul-Rahim Al-Saati, The Permissible Gharar (Risk) in Classical Islamic Jurisprudence, J.KAU: Islamic Econ.,Vol. 16, No. 2, pp. 3-19 (1424 A.H / 2003 A.D)

[56] Imam-Al-Baji (1332 A.H.), *Al-Muntaqa Sharh Al-Muwatta*, Darul-Kitab-al Arabi, Birut,Vol.1,P.41.

[57] Ibn Taymiyyah, collected fatawa(AH 728), *Al-Qawa'id, Al-Nuraniyya-al-Fiqhia,Al-Kordi edition*, p. 116.

1- The "pebble", "touch" and "toss" sales.

2- Selling the unborn animal without its mother.

3- Selling the fetus and embryo.

4- Selling fruit before its emergence.

5- Selling the unborn animal (*habal-al-habalah*).

6- Selling the find of a diver.

7- Selling the object of unknown identity.

8- Selling an object of unknown genus.

9- Deferment of the price to an unknown future date.

Second: The Permissible *Gharar*:

According to Shatibi, the *Hadith* (which prohibits *Gharar*) does not intend to prohibit all *Gharar* because jurists permit some transactions which have *Gharar* such as selling what is hidden in the ground, selling a house though its foundation has not been seen. The Hadith intends to prohibit *Gharar* which can cause dispute and cannot be tolerated.[58] *Istihsan* is used by jurists to permit some *Gharar* transactions, and they stipulate conditions to reduce the cause of dispute to acceptable level. Accoridng to al-Shatibi, Imam Malik and Abu Hanifa consider *istihsan* as particularisation of general on the basis of stronger evidence which is either obvious or implied. This was inclined by Imam Malik on the basis of *maslahah*, which means giving preference to a particular *maslahah* over the general ruling of *qiyas*. This departure can be from an obvious *qiyas* to a hidden *qiyas*, and must rely on specific evidence, which may be ruling of the text, general consensus, nessessity, public interest or custom, it must be persuasive enough to convince the *mujtahid* that there is a case of *istihsan*.[59]

Gharar can be permissible when there is no general agreement among the schools of jurisprudence that this *Gharar* is prohibited and the contract that involves this *Gharar* is invalid. If at least one

[58] Al-Shatibi, A.I., (n.d.), *Al-Muwafaqat*, ed., S.A. Diraz, IV, p. 208.
[59] Ibid

school permits it with or without conditions, then it is considered permissible *Gharar*[60]. The following are some cases of the permissible *Gharar*:

1. **Two sales in One**

The ban on combining two sales in one is reported in a number of authenticated *hadiths*, but jurists have differed in interpreting these *hadiths*. They specified instances to which it applies. One of these is, (two sales in one) which means that a single contract relates to two sales. This can be when seller says, "I sold you this item at a hundred in cash today and hundred and ten a year hence". The buyer says, "I accept", without specifying at which price he buys the item. If this sale is binding there will be *Gharar* in the price as the seller does not know what price he will receive. But if this sale is not binding in any of the two forms and one or both of them has option to choose, then Maliki school accepts it as it is one of the allowed options in the school.[61]

2. **The option sale (Arbun Sale)**

In this sale, purchaser pays down payment and he has the option to default, so if he takes the item, the amount paid will be part of the total price. But if he does not, he would forfeit the down payment and the seller will keep it.

There are two hadith on the (*arbun* sale). One narrated by Malik says that "The Prophet (pbuh) has forbidden *arbun* sale"[62]. The other which quotes Zaid Ibn Aslam as saying that he asked the Prophet (Pbuh) on *arbun* as part of a sale and that Prophet permitted it.[63].

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[60] See Kamali, M.H.,(1417 A.H.),*Istihsan and its Application*, (1977),(IRTI, IDB),Jeddah, p.42-44.

[61] See Al-Qurtubi, (1370 A.H.), *Bedayat-Al-Mujtahed*, II/154, Al-Mudawwnah, 9/151, Al-Shawkani, Nayl Al-Awtar, 5/249.

[62] Malik, Imame Malik,*Al-Muwatta*, on the margin of Muntaqa 4/157.

[63] Shawkani (1372 A.H.), Nayal Al-Awtar, ,Matba`ah, Mustafa al –al-Halabi, Cairo15/250.

Muslim Jurists have disagreed on the permissibility of *arbun* sale, it is prohibited by the Hanafis, the Malikis, the Shafi'is and Zaidi Shi'ites. But it was approved by Imam Ahmed who narrated its permissibility on the authority of Umar and his son and others.

Even though in Islamic Sharia, sale is a binding contract if it meets its conditions, Sharia permits option to protect contractor benefits and his contentment and to prevent society from enmity and hatred as seller or buyer may conclude the transaction in unfavored conditions, and they regret the deal later, so conflicts and disputes may arise in execution of the contract and this will destabilize the transaction.

Despite the *Gharar* involved, Sharia permits option sale where the buyer may have the option to default with two conditions: (1) they have to agree on that in advance; (2) there must be a reason to justify the option.[64].

3. **Conditional (*Muallaq*) Sale:**

In this sale the conclusion of it is made conditional upon another uncertain event through the use of a conditional clause. For example seller would say, "I will sell you my house if so and so sells me his". The buyer would say, "I accept". Majority of jurists consider this sale as null and void because of the *Gharar* involved, as both parties do not know whether the subject matter of the condition will be realized and the sale will be completed or will not as the condition will not obtain. And there is *Gharar* in the time as to when will it conclude as none of them know when the condition will occur.[65]

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[64] **Al-Jaziri,** (1987), *Kitab Al-Fiqh*, Dar Ihya al- Turath al-Arabi, Beiryt,vol,2,pp.170-171.

[65] Al-Nawawi (n.d.), *Al-Muhadhdha with Al-Majmuh*, Cairo, vol,9, p.340.

Ibn Taymiyah considers suspended sale with condition as permitted. If these conditions are achieved, parties benefit provided they do not contradict the Quran and Sunnah text[66]. In his view conditional sale is valid as it contains no *Gharar*. If condition would meet, then the sale will be executed otherwise there will be no sale contract.

Third: The Mandatory Uncertainty

In this case *Gharar* (uncertainty) is a prerequisite to the validity of the contract. This is the well-established view concerning the *musharakah*, *ijarah* and *mudarabah* contracts. This is based on the on the Prophet (pbuh) saying "Usufruct devolves with liability"[67]. In the *musharakah* contract all parties are partners in case of profit and liable in case of loss and no minimum profit can be assured to one party, or one party is entitled to a share in profit only while the other party is made liable for the entire loss along with his share in profit as these situations could contradict the above maxims. In *mudarabah* contract, the financier, or *rabb al-mal* is the only one liable to loss if there is any and he cannot be guaranteed the principle of minimum profit by the *mudarib*, or the working partner. In a renting or leasing contract the tenant or lessee cannot be liable to damages in the house or equipments if these damages are due to earth quake or flood because the owner who is earning its rent should also bear the loss. In current accounts, where the depository is liable to guarantee and return the deposit, he is entitled to take away any profit out of that deposit if it is invested.[68]

1.6 Risk versus undesirable consequences

An undesirable event is something whose occurrence we do not like. Risk is the likelihood of its occurrence. Thus, the risk in drawing an insurance policy on life for some one who has crossed the

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[66] Ibn Al-Qayyim (n.d.), *I'alam Al-Mawaqqi'in*, vol,3,pp.337-33.
[67] Abu Dawud, sunan, H.no 3508,vol3,p.777
[68] See Kamali, M.H.,(1417 A.H.),*Istihsan and its Application*, (1977),(IRTI, IDB),Jeddah, p.45.

age of 70 is higher due to a higher chance of his dying during the period of the contract, as compared to an insurance policy for a person who is in the prime of his youth.[69]

1.7 The Importance of Risk Analysis in Financial Decisions

Risk analysis is the greatest common factor in financial decisions. After someone has determined his target, the first priority for him is to assess the forces that can possibly alter the course of events so as to prevent reaching the target. Financial decisions rely on expectations about what is likely to happen in future. Expectations are not realized unless events occur in the expected manner. Accordingly, the analysis of forceps that can possibly lead to deviations from the expected course is exactly what is involved in the study of risk. The purpose is not elimination of risk for that is an impossible task. The purpose is to measure the risk involved so as to ensure that the person taking the decision receives compensation commensurate with the extent of risk he is bearing. The rule in requiring compensation suitable for the extent of risk is that people in general are risk-averse, i.e., they always prefer less risk to more risk.[70]

1.8 Purpose of studying risk

The purpose of studying risk is not its elimination because that is not possible. The purpose is to acquire some control over it and to manage it in a way that reduces its harmful effect in decisions that we need to take.

[69] See, Chicken, C. J., (1966), Risk Hand Book, International Thomson Business Press, p. 11.
[70] See, Knight, F.H. (1921), Risk, Uncertainty and Profit, Chicago: University of Chicago Press,P.65

CHAPTER-II

2. RISK IDENTIFICATION IN ISLAMIC MODES OF FINANCE:

Islamic finance is typified by products which are based around a small number of contracts. Risk in Islamic finance revolves around the nature of these financial contracts. Because of the methods stipulated for participation, however, Shari'ah-compliant financial products are quite different from their conventional counterparts. Islamic financial institutions (IFIs) are exposed to credit risk, market risk, operational risk, equity investment risk and 'rate of return' risk. *Musharakah, mudarabah, murabaha, ijara, salam, and istisna* are some of the more popular types of Shari'ah-compliant contracts.

In order to identify and understand the risks that Islamic Modes of finance face, I first briefly discuss the practical nature of these modes of finance. To have the discussion in some perspective, I outline the types of Islamic Modes of finance. The whole practice of Islamic finance is based on modes that do not involve interest. As a general rule, they involve the carrying out of investment and/or the purchase of goods, services and assets.

2.1. Major Islamic Financing Techniques.

Theoretically, there are a large number of financing techniques. The State Bank of Pakistan has approved 12 Islamic modes of financing, to be used as alternatives to interest based financing. We will limit ourselves here to a very brief practical review of the six basic modes being largely

used by most Islamic banks, which provide financing using two basic methods. The first depends on profit-and-loss sharing and includes *mudarabah* and *musharakah.* In this case the return is not fixed in advance and depends on the ultimate outcome of the business. The second involves the sale of goods and services on credit and leads to the indebtedness of the party purchasing those goods and services. It incorporates a number of modes including *murabahah, ijarah, salam* and *istisna.*The return to the financier in these modes is a part of the price.[1]

These modes of finance are unique for two main reasons. First, the debt associated with financing by way of markup results from the sale/purchase of real goods and services rather than the lending and borrowing of money Secondly, the introduction into banking of modes that depend on profit and loss sharing bring important advantages. It has almost the same economic effects as those of direct investment, which brings pronounced returns to economic development.[2]

2.1.1 Mudarabah (Silent/ Passive Partnership)

Mudarabah is a kind of partnership, wherein one party provides finance to the other for the purpose of carrying on trade. According to Ali al-Khafif "*Mudarbah* is a contract for sharing the profit of a business in which one party contributes with capital and the other with his labour"[3] - the party who provides the finance, is called the "*Rabb al-Mal*", whereas the other party who

[1] See Ahmad Ausaf Dr., *Contemporary Practices of Islamic Financing Techniques* (1993) IRTI, Jedda Saudi Arabia, research paper no. 20 P.44
[2] See Jarhi (1981). *Islamic Modes of Finance*, IRTI, Jeddah,Part 2, P.29
[3] Ali al-Khafif, *al-Sharikat fi al- Fiqh al-Islami*, Maktabah tawfiqiyyah cairo:1399/1979, p.154

actually works for the *Mudarabah* is called the "*Mudarib*" – on the condition that the profit will be shared by both the parties on the basis of an agreed ratio; and in case of loss the same shall be borne by the Rabb al-Mal and not the *Mudarib*, Therfore it is not valid to leave profit unsettled at the time of agreement.[4]

Participation in the profit, at a ratio, mutually agreed, is an essential ingredient of the contract. A Mudarabah contract cannot, therefore, be concluded without determining participation in the profit, at a certain ratio.The *Mudarib* receives the property "mal" as a trustee, because he takes possession of the same at the desire of the proprietor. He is neither a borrower nor a purchaser or a pawnee. The provisions of Islamic law relating to trust (*amanah)* will, therefore, be attracted to the various incidents of *Mudarabah.*[5]

As a mode of finance applied by Islamic banks, on the liabilities side, the depositors serve as *rabb-al-mal* and the bank as the *mudarib. Mudarabah* deposits an be either general, which enter into a common pool, or restricted to a certain project or line of business. On the assets side, the bank serves as the. *rabb-al-mal* and the businessman as the *mudarib* (manager). However the manager is often allowed to mix the *mudarabah* capital with his own funds. In this case profit may be distributed in accordance with the ratios agreed upon between the two parties, but the loss must be borne in proportion to the capital provided by each of them.[6]

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[4] See Mansoori. Dr.Muhammad Tahir, *Islamic Law of Contract and Business Transaction*, Shariah Academy, IIU, Islamabad p.282.

[5] See Dr. Tanzilur Rahman *Mudarabah and the Pakistan perspective* p.5

[6] See Jarhi (1981*). Islamic Modes of Finance,* IRTI, Jeddah Part 2 P.2

In this arrangement i.e. an investment manager, the client, and the capital owner, the Islamic banks that acts as a silent partner, all the capital needed to the operation is provided by the Islamic bank while client provides the expertise, management and labouir required for the operation. *Muidarabah* contract does not guarantee any fixed rate of return. The profits which results from this enterprise are shared between the bank and the client, entrepreneur, according to a prefixed percentage. In case of loss, which does not result from negligence or misconduct on the part of the entrepreneur, the bank has to bear losses and the entrepreneur's loss lies in not getting any reward or compensation for his effort.[7]

In Pakistan, in June 1980, as an alternate to riba, the Federal Government took, as a first step, to introduce the *Mudarabah*, as an Islamic mode of investment, by promulgating *Mudarabah* Companies and *Mudarabah* (Floatation and Control) Ordinance, 1980 and the *Mudarabah* Companies and Mudarabah Rules, 1981 made under Section41 of the said Ordinance, published in the Gazette of Pakistan, Extraordinary, Part I, dated 26-06-1980 and the Gazette of Pakistan, Extraordinary Part II, dated 26-01-1981 respectively.[8]

Although it has been widely suggested in the theoretical literature on Islamic banking that *Mudarabah* can be a viable basis of financial intermediation in an interest free framework, there are certain difficulties with its contemporary application. For example, the legal system operating in the country should provide legal safeguards to the provider of capital so that he can finance projects on the basis of *Mudarabah*. For this and other reasons, the number of banks

[7] See BEN ARAB Mounira, *Managing Risks And Liquidity in an Interest free banking framework*, , International Journal of business and Management, Vol.3, no.9, P.84)

[8] See Dr. Tanzilur Rahman *Mudarabah and the Pakistan perspective* p.16

providing finance on the basis of Mudarabah is not very large. Even among those banks which use Mudarabah as a financing technique, the frequency of its use is not very high. In view of the dearth of relevant information, it is not easy to describe the manner in which different Islamic banks practice *Mudarabah* and whether there are any differences in these practices the prescribed were only the basic ingredients and information.

2.1.2 Musharakah (Active Partnership)

The profit-and-loss sharing system has its roots in the ancient form of financing practiced by Arabs since long before the advent of Islam. After the introduction of Islam, this system was permitted to continue and was legitimatized as a finance instrument. For this historical reason, scholars consider profit-and-loss sharing financial instruments to be the most authentic and most promising form of Islamic contracts.[9]

The literal meaning of the word *Musharaka* is mixing or mingling. Sharikah or partnerhip implies an underlying idea of mixing shares in such a way that one of them can not be distinguished from other. In technical sense, sharikah signifies a particular relationship that exists between two contracting parties,although there may be no actual mixing or mingling of shares.[10] Under Islamic law, *Musharaka* refers to a joint partnership where two or more persons combine either their capital or labor, forming a business in which all partners share the profit

[9] See Ariff, M. (1988). *Islamic Banking.* Asian-Pacific Economic Literature, Vol. 2, no. 2, p.46.
[10] See Mansoori, Dr.Muhammad Tahir. *Islamic Law of Contract and Business Transaction*, Shariah Academy, IIU, Islamabad p.282.

according to a specific ratio, while the loss is shared according to the ratio of the contribution[11] It is based on a mutual contract, and, therefore, it needs to have the following features to enable it to be valid:

- Parties should be capable of entering into a contract (that is, they should be of legal age).
- The contract must take place with the free consent of the parties (without any duress).

In *Musharaka*, every partner has a right to take part in the management, and to work for it. However, the partners may agree upon a condition where the management is carried out by one of them, and no other partner works for the *Musharaka*. In such a case the "sleeping" (silent) partner shall be entitled to the profit only to the extent of his investment, and the ratio of profit allocated to him should not exceed the relative size of his investment in the business. However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business, and work done by any of them in the normal course of business shall be deemed as being authorized by all partners. [12]

Musharaka can take the form of an unlimited, unrestricted, and equal partnership in which the partners enjoy complete equality in the areas of capital, management, and right of disposition. Each partner is both the agent and guarantor of the other. Another more limited investment partnership is also available. This type of partnership occurs when two or more parties contribute to a capital fund, either with money, contributions in kind, or labor. Each partner is only the

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[11] See Zuuhayli, Wahba Zuhaili, *al-Fiqh al-Islami wa addillatuhu*, Damascus, Dar al-Fikr, vol. 4, pp.415-412
[12]Hussain G. Rammal, *Financing Through Musharaka: Principles And Application* , p.5

agent and not the guarantor of his partner. For both forms, the partners share profits in an agreed upon manner and bear losses in proportion to the size of their capital contributions.[13]

'Interest' predetermines a fixed rate of return on a loan advanced by the financier irrespective of the profit earned or loss suffered by the debtor, while *Musharaka* does not envisage a fixed rate of return. Rather, the return in *Musharaka* is based on the actual profit earned by the joint venture. The presence of risk in *Musharaka* makes it acceptable as an Islamic financing instrument. The financier in an interest-bearing loan cannot suffer loss, while the financier in *Musharaka* can suffer loss if the joint venture fails to produce fruits.[14]

In practice the Mudarabah and Musharaka contracts have real problems with moral hazard and asymmetric information which are serious in thses kinds of arrangements. A trustworthy entrepreneur is the cornerstone of these arrangements. Consequently, the fact that the bank or investment account holder bears all the loss of the investment in the event of failure may encourage the entrepreneur to behave against the interests of the bank. Moral risk may arise when the entrepreneur declares a loss or a profit lower than the real; because of lack of honesty and integrity. The Islamic bank must have access at all times to the entrepreneur's accounts to inspect and keep track of the accounts, If any misconduct, dishonesty or negligence is established against a client, he will be subject to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specified period[15].

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[13] See Lewis, M.K. & Algaoud, L.M. (2001). Islamic Banking. Cheltenham, UK: Edward Elgar.p.43.
[14] Usmani, M.T. (1998). An Introduction To Islamic Finance, Idaratul Ma'arif Karachi, Pakistan:p. 27
[15] See , BEN ARAB Mounir Managing Risks and Liquidity in an Interest free banking framework, International Journal of Business and Management, Vol.3, no.9, p.84

2.1.3 Diminishing Partnership

When used in home financing, *Musharaka* is applied as a diminishing partnership. In home financing, the customer forms a partnership with the financial institution for the purchase of a property . The financial institution rents out their part of the property to the client and receives compensation in the form of rent, which is based on a mutually agreed fair market value. Any amount paid above the rental value increases the share of the customer in the property and reduces the share of the financial institution. The financier will gradually sell his share to the beneficiary at an agreed price and in accordance with an agreed schedule[16]

2.1.4. Murabahah (Sales Contract at a Profit Markup)

In *Murabaha* which is commonly referred to as 'cost-plus financing' or 'mark-up financing', the seller discloses the true cost of the product and then adds a mark-up to sell it at an agreed price to the customer. Payment can be at spot or in the future. *Muraba*ha is a sales contract and hence should honour all the requirements of a valid contract of sale under Shari'ah namely:

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- The commodity should be certain and an existing commodity and not a future commodity which is going to be produced or cultivated;
- The seller must be the owner, either physical or constructive, at the time of sale;
- The sale cannot be conditional and must have a fixed consideration;
- The commodity must have value at the time of sale. [17]

[16] See Hussain G. Rammal Financing Through Musharaka: Principles and application p.8.
[17] See See Zuuhayli, Wahba Zuhaili al-Fiqh al-Islami wa addillatuhu, vol 4, pp 704-706

Under this contract, the client orders an Islamic bank to purchase for him a certain commodity at a specific cash price, promising to purchase such commodity from the bank once it has been bought, but at a deferred price, which includes an agreed upon profit margin called markup in favor of the bank.[18]

Thus, the transaction consists of an order accompanied by a promise to purchase and two sales contracts. The first contract is concluded between the Islamic bank and the supplier of the commodity. The second is concluded between the bank and the client who placed the order, after the bank has possessed the commodity, but at a deferred price, that includes a markup. As a result the, financing of the client by the bank does not occur through the transfer of money, but through the transfer of a tangible asset. The deferred price may be paid as a lump sum or in installments. In the contract between the Islamic bank and the supplier, the bank often appoints the person placing the order (the ultimate purchaser) as its agent .to receive the goods purchased by the bank. [19]

The condition of its validity is based on the fact that the bank must have the ownership and possession of the commodity before it can sell it to its client. Possession may be physical or constructive. The later means a situation where the bank has not taken the physical delivery of the commodity yet it is in control of the commodity with all the rights, liabilities and risks including the risk of destruction. In modern day trade and commerce, physical possession may not matter in the presence of adequate documentation showing ownership and constructive

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[18] Mabid Aljarhi And Munawar Iqbal *Islamic Modes of Finance*,IRTI, Jeddah Saudi Arabia, Part 2 P.3

[19] .See BEN ARAB Mounira, *Managing Risks and Liquidity in an Interest free banking framework*, International Journal of Business and Management, Vol.3, No.9, p.83)

possession. The order placed by the client is not a sale contract but is merely a promise to buy. In cases where the promise is not binding on the client; the client even after putting an order and paying the commitment fee can rescind from the contract. The Islamic bank bears the risk of possession the commodities until they have been delivered to the client.

In contrast to the interest system in which delayed payments would automatically mean increased interest payments, the late payments by the client cannot be penalized in Murabaha contract as Islamic banks cannot, in principle, charge anything in excess of the agreed upon price. Non-payment of dues in the stipulated time by the counterparty implies loss to banks. To overcome this problem, a penalty may be applied in the case of delayed payments. This amount thus collected from penalty should be used for charitable purposes. In the event of default in payment an immediate claim can be made on the remaining installments. The Islamic bank may obtain some collateral from the client to ensure payment.[20]

2.1.5 Ijara-Based Financing

The term *Ijara* (Leasing) in Arabic literally means to give something on rent. *Ijara* contract is an agreement wherein a lessor *(mu'ajjir)* leases physical asset or property to a lessee *(musta'jir)* who receives the benefits associated with ownership of the asset against payment of predetermined rentals (*ujrah*). *Ijara* is for a known time period called *ijara* period. The contract of *ijara* financing can be utilized as a mode of financing to provide the customers with short to medium-term financing to lease such items which may include: real estates, buildings,

[20] See Sunil Kumar Dr,(Academic Article: *Risk management in murabaha*, 01 April, 2008

equipments, machineries, computers, motor vehicles, and other acceptable (not be *haraam* or forbidden assets).[21]

Ijara, or Islamic leasing, is one of the most easily recognizable Islamic asset financing techniques which is commonly used in a singular leasing transaction and, increasingly, as a building block in larger and more complex transactions. Being one of the simplest asset-based Islamic financial instruments, *Ijara* has steadily gained prominence as an alternative financing tool to conventional financing structures. The growing popularity of the structure in project financing has crossed over to the shipping industry, not surprising given its good track record in financing large and expensive assets.[22]

Like any other contract, a lease contract has to fulfill all of the conditions of a valid contract stipulated by the Shad' ah. For example:

1. Asset to be leased must have a valuable use. Therefore, things having no usufruct at all can not be leased.[23]
2. Asset to be leased must not be consumable. That is, it can be returned to the lessor in its original form at the end of the lease period. Normal wear and tear accepted.
3. Ownership of the asset remains with the lessor and only the usufruct is transferred to the lessee. Usufruct means the right of using another's property for profit, with out spoiling its substance, therefore, the lease con not be affected in respect of money, eatables, fuel and ammunition.[24]

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[21] Usmani, M.T. (1998). An Introduction to Islamic Finance: Idaratul Ma'arif Karachi, Pakistan.p.27.
[22] See Marine Money,To Lease or not to Lease: Ijara as a Viable Ship Financing Structure, Asia Edi Tion-vol.3, p.4, issue 14 July 03, 2008
[23] Mansoori, Dr.Muhammad Tahir. Islamic Law of Contract and Business Transaction, Shariah Academy, IIU, Islamabad p.282
[24] See Usmani, M.T. (1998). An Introduction to Islamic Finance: Idaratul Ma'arif Karachi, Pakistan.p.157

4. Liabilities and risks incidental to ownership will reside with the lessor.
5. Period of the *ijara* arrangement must be clearly specified
6. Purpose and mode of usage should be agreed upfront
7. The leased asset is a trust in the hands of the lessee. Lessee liable for damage to leased asset only to the extent of the lessee's negligence.
8. Lessee does not guarantee the safeguarding of the leased asset nor indemnifies the lessor of damages
9. Rental payment must commence after the delivery of the leased asset either actually or constructively (e.g. give keys to house)
10. The subject matter of *Ijarah*, namely, the usufruct should be known, and identified. It is not permissible to lease an unspecified thing. Thus if a person says "I rented you one of these two houses", the contract would be invalid because the subject-matter In this case is unknown and unidentified.[25]
11. Upon loss or non-existence of usufruct, the *ijara* contract is terminated etc.
12. Rent should not be paid in the same genus or specifies. Thus, a house cannot be rented in exchange of house.[26]

These conditions become more important in a lease contract because there is more room for uncertainty (*Gharar*). Hence, it is necessary that the benefits and costs of each party are clearly stated in the contract. During the period of lease, the asset remains in the ownership of the bank but the physical possession of the asset and its right of use is transferred to the

[25] Kasani,*Badai al-Sana`i`fi Trtib al- Shara`,i,* Cairo, Sharikah al- Matbu`at al- Islamiyyah, (1910),vol.4 p.180.
[26] Ibid

lessee. After the expiry of the leasing period these revert to the lessor. A lease payment schedule based on the amount and terms of financing is agreed upon by the bank and the lessee. The agreement may or may not include a grace period. According to the Islamic view, the maintenance of the asset during the leasing period is the responsibility of the owner of the asset, as the benefit (rental) is linked to the responsibility (maintenance).

Leasing is one of the approved methods of interest free financing in Pakistan. In fact, the utilization of PLS deposit funds into leasing operations was authorized by the State Bank of Pakistan as early as 1982, even before the beginning of the full scale Islamization of banking in Pakistan. Furthermore, by means of a circular issued in 1984, the State Bank of Pakistan indicated areas where leasing could be used. It was envisaged that the main recipients of leasing based finance would be the agricultural sector where all kinds of equipment, such as tube wells, tractors, trailers, fishing boats, and solar energy plants, other farm machinery and transport equipment, etc. could be leased.[27]

2.1.5.1 Types of Ijara arrangements

In conventional leasing, there are two types of leases Operating lease – where the lessor owns the asset and bears maintenance costs as well as ownership risks Financial lease – where the lessor

[27] See Ahmad Ausaf Dr. *Contemporary Practices of Islamic Financing Techniques*, IRTI, Jedda Saudi Arabia,1413H, (1993) Research Paper No. 20 pp.45-49

only "technically" owns the asset, maintenance costs and ownership risks are borne by the lessee.[28] In Islamic finance, there are many types of *Ijara* financing arrangements:

i. Simple Ijarah (Operating Lease)

Simple *ijarah* that is not tied with a purchase agreement is more commonly known as operating lease. Such transactions are suitable for expensive assets such as ships, aircraft, and heavy-duty industrial and agricultural equipment. This type of lease is also called a service lease, or a true lease. It is a short-term arrangement. The full cost of the equipment or property is not amortized during the primary lease period.

The lessee may cancel the lease any time he wishes to do so without paying any penalty, with a prior notice according to the contract.[29]

In an *Ijara,* the title of the equipment or property always remains with lessor irrespective of how much the lessee has paid out as lease installments. Consequently, the risks and responsibilities of ownership are always borne by the lessor.

In this type *ijara*, ownership of the asset remains with the lessor (bank), the asset reverts to the bank at the end of the lease period. The bank may then lease it out to another customer if the asset is in good shape.

This type of *ijara* can be presented in one of the following three structures:

1. The simplest form of *ijara* involves the bank as the owner of an asset and leasing it out to its customer against predetermined rentals for an agreed period of time. The identity of

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[28] Ibid

[29] Mansoor, Dr.Muhammad Tahir, Islamic Law of Contract and Business Transaction, Shariah Academy, IIU, Islamabad p.236

the bank is same as that of the vendor of the asset. From an Islamic point of view, this is the most ideal type of *ijara* as it conforms entirely to features of the classical *ijara*. However, this is also the least common and the least popular structure. An Islamic bank usually does not deal in a variety of physical assets.

2. In real life, usually there is an involvement of a vendor in the process. In this structure, there are two distinct phases in the arrangement. In phase one, the bank purchases the asset needed by its customer from the vendor. In phase two, the bank as owner of the asset leases out the same to its customer against predetermined rentals for an agreed period of time.[30]

3. Another possible scenario is when the bank would not like to deal directly with the vendor in connection with the first purchase/sale of the item. The bank here appoints the customer as its agent. In this case, there are two separate sets of relationships between the bank and its customer. In the first instance, the customer is an agent of the bank in respect of purchase of the asset on behalf of the bank. The second stage begins from the date when the customer takes delivery from the supplier. At this stage, the relation of lessor and lessee comes into existence. These two capacities of the parties should not be mixed up or confused with each other.

The simple three-party financing process with the customer as an agent is presented below. The other two structures are the same with necessary modifications.

[30] See Ahmad Ausaf Dr, Contemporary Practices of Islamic Financing Techniques, IRTI, Jedda Saudi Arabia,1413H, (1993) Research Paper No. 20 pp.47-51

1. There is an agreement of mutual promise between Bank and Customer whereby the Bank promises to lease and the Customer promises to take on lease the asset against predetermined rentals for a definite time period;
1. Bank appoints Customer as its Agent;
2. Customer identifies the vendor, selects the asset on behalf of the bank and advises its particulars, including the vendor's name and its purchase price to the bank in writing;
3. Vendor makes physical delivery of asset to Agent (Customer) of Bank; trained staff from bank oversee the process of customer taking physical possession of asset;
4. Bank makes arrangement for payment of purchase price to Vendor;
5. The agency contract comes to an end; Bank leases the asset on the basis of the agreement of mutual promise, transfers possession and right of specified use to Customer;
6. Customer pays known rentals over future (known) time period(s).**(reference)**
7. Asset reverts back to Bank.[31]

ii. Ijara-thumma-al-Bay' (Lease-sale) or (Financial Lease)

Businesses often require financing to purchase machinery, equipment, other fixed assets and land and buildings. To address this need, Islamic financial institutions have resorted to a type of *ijara* contract which is loosely comparable to the conventional financial lease. It is a combination of leasing movable or immovable property with granting the lessee an option of eventually acquiring the object of the lease[32]

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[31] Ibid
[32] Nabil A. Salih, *Unlawful Gain and Legitimate Profit in Islamic Law*. P.122.

In *ijara*-thumma-al-Bay' (lease-sale), or as some call it "*Ijara-wa- Iqtina'a*" or *"Ijara muntahiea bitamleek"*, the lessee is offered the option of ultimately purchasing the asset or property at the end of *ijara* period at a predetermined price. The basic idea is for the bank to finance the purchase of an asset via a leasing arrangement and at the end of lease period, ownership of the asset is transferred to the customer.

In this type of *ijara*, the full cost of the asset or property is amortized during the lease period; that is why it is called by some as "full payment lease". This type of leasing cannot be canceled except if the lessor is compensated for any losses.[33]

Ijara-thumma-al-Bay' cannot be constructed to imply that it is a combination of two different contracts.; that is, it is not a leasing (*ijara*) contract with a condition to sell. Rather, it involves two different contracts to be executed at two different stages. First contract is a leasing contract (*ijara*) with a unilateral promise (*wa'ad*) to sell the asset to the customer at a predetermined price. Once the lease expires and lessee has made all payments, the lessor is obliged to fulfill his promise to sell by executing the contract of sale (*bay'*). Such a promise is made as an additional agreement to the main *ijara* agreement. From the standpoint of the customer, such promise may be seen as an option to purchase the asset at the end of the lease period. Since an option is a right without obligation, by implication, the unilateral promise must be binding on the bank.

Note that the sale contract is independent of the *ijara* contract. In an *ijara-thumma-al- Bay'*, the bank remains the owner till the very end bearing all the risks and responsibilities, and the customer is responsible for only the rentals as long as he uses the equipment or property. He becomes the owner only if, and when, he exercises his option to purchase at the end of the

[33] See Ahmad Ausaf Dr, *Contemporary Practices of Islamic Financing Techniques*, IRTI, Jedda Saudi Arabia,1413H, (1993) Research Paper No. 20 pp.47

period. According to a decision of the OIC Fiqh Academy, this second transfer of ownership contract should be signed only after termination of the lease term, on the basis of an advance promise to affect such a transfer of ownership to the lessee. Rent installments are calculated in such a manner as to include, in reality, recovery of the cost of the asset plus the desired profit margin.[34]

iii. *Ijara* with *Musharaka or Mudharaba*

Another method of *ijara* ending with transfer of ownership to the customer is provided by a combination of *ijara* with partnership (based on *musharaka or mudharaba*). This structure is quite common in housing finance, where the bank and its customer enter into a partnership specifically formed to finance the acquisition of the property that the customer is interested in. The bank and the customer contribute to the equity of the partnership in a certain ratio. Nevertheless, the bank acts as the agent-manager of the partnership. The partnership then purchases the property and leases it to the customer against known periodic rentals. The proportion of rental accruing to customer is used to redeem part of the bank's stake in the property. This results in a decrease in the bank's stake over time. Eventually, the bank's stake in the property reduces to zero and the customer becomes the full owner of the property. The mechanism that uses diminishing *musharaka or mudharaba* in combination with *ijara* is a recent innovation in Islamic banking and finance.[35]

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[34] See Mabid Aljarhi And Munawar Iqba l (1981) *Islamic Modes of Finance*, IRTI, Jeddah, Part 2 P.6
[35] Ibid

iv. Sale-and lease back

While in *murabaha* the identity of the vendor has to be different from that of the customer. This constraint is not relevant in the context of *ijara.* In a sale-and-lease-back arrangement the customer may sell an asset that it owns, to the bank for a price and then take it back on lease. The result is an immediate cash inflow for the customer (in the form of sale price of the asset). The customer continues to use the asset in lieu of periodic *ijara* rentals paid to the bank, which now owns the asset.

The process of a sale-and lease-back is presented as follows

1. Customer sells an asset it owns to Bank on cash basis; (Possession of the asset remains with the Customer while ownership papers are transferred to the Bank)
2. Customer enters into an *ijara* contract with Bank for the same asset;
3. Customer pays known rentals over future (known) time period(s).
4. Bank transfers ownership of asset to customer at the end of *ijara* period either through gift or sale.[36]

2.1.6 *Istisnā'* Financing

Before discussing these two products *(Salam and Istisna)* it is important to remember that in order for a commodity to be sold while still biding by Shari's law, three conditions must be satisfied.

1. The commodity must be in existence

[36] Sharioah Coordination, *Shariah Standarad*, Behrain, No.3,

2. The commodity must be owned by the seller at the time of sale.

3. The commodity must be in the physical (or constructive) possession of the seller at the time of sale.

Due to the *Hadith* : "Do not sell what is not with you"[37]

There are only two exceptions to these general principles in the Shariah. One is *salam* and the other is *istisna'*. Both are sales of a special nature

According to most authoritative Arabic dictionaries, the word *Istisna'* is derived from the word Sana'a which literally means "making, manufacturing, or constructing something".[38] Although the dictionary meaning of the word is to make a thing, its juridical meaning is disputed among the jurists. Some jurists define it by giving examples; others tackle it through its essence and attributes. For instance, it is defined as "a contract with a manufacturer to make something".[39] However, al-Zarqa defined it as a contract of selling a manufacturable thing with an undertaking by the seller to present it manufactured from his own material, with specified descriptions and at a determined price.[40]

It is necessary to study the distinctive features of *Istisna'* and its independence to avoid some of the confusing expressions reported by some scholars in this area. First, the Malikis, Shafi'is and Hanbalis consider Istisna' as a variation of *Salam*, then they subsume it under the definition of *Salam*. On the other hand, some of the Hanafi scholars considered *Istisna'* as a pure *Ijarah.* Others considered it as *Ijarah* at the beginning and a sale at the end of the contract.

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[37] Abu Dawud, *Sunan*, Hadith No. 2187.
[38] Ibn Manzur, Muhammad Ibn Mukarram, *Lisan al-'Arab*, Dar Sadir, Beirut, Lubnan, 1955, vol. 8, p. 208.
[39] 'Al a' al-Din al-Samarkhandi, *Tuhfat al-Fuqaha'*, Mat ba'at Jamiat Dimashq, Damascus, 1983, vol. 2, p. 538.
[40] See Zarqa, Mustapha Ahmad. 'Aqd *al-istisna' Wa mada Ahammiyyatuhu Fi al-Istitmarat al-Islamiyyah al-Mu'asira* (Lecture Series of Renowned Scholars No. 12), Islamic Development Bank, Jeddah, 1995, p. 21.

First of all, despite the fact that *Istisna'* and *Salam* have some points of similarity, such as the non-existence of the subject-matter or the future delivery, there are some points of differences as:

(1) The subject-matter in *Istisna'* is always something that needs manufacturing while Salam is possible in anything whose descriptive conditions can be fulfilled;

(2) It is necessary in a *Salam* contract that the price is paid in advance while in Itisna' it can be prompt, deferred or paid in instalments;

(3) The classical jurists have also maintained that *Salam* is binding while *Itisna'* is not. However, this is not the modern approach;

(4) The classical jurists have also pointed out that the time of delivery is an essential part in the contract of *Salam* while it is not necessary in *Itisna'*. However, modern jurists reject this point of difference.[41]

Concerning the relation between *Itisna'* and *Ijarah* it should be noted that the manufacturer in *Itisna'* undertakes to make the required goods with his own material. However, if the customer provides the material, and the manufacturer is required to use his labor and skill only, then, the transaction is not *Itisna'* but becomes *Ijarah* instead.

Regarding the point of similarity between *Itisna'* and *fu'alah* is that in both contracts the work or the labor is a condition, but they differ in the fact that *Itisna'* is only possible in manufactured goods while *fu'alah* applies to everything. Furthermore, the labor can be well determined in

[41] See Muhammed Al-Bashir Muhammed Al-Amine, *Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] pp 22-48.

Itisna' but this might not be the case in fu'alah. In addition, they differ in their subject-matter which in the contract of *Itisna'* is the labor and the material, but it is only the labor in *Fu'alah.*

With reference to the relation between *Itisna' and Murabahah* it should be noted that *Murabahah* is basically the sale of goods at a price covering the purchase price plus a margin of profit agreed upon by both parties concerned while *Itisna'* is a contract where the deal can be referred to something not in existence at the time of concluding the contract. However, *Itisna'* has some more advantageous characteristics as a method of investment by directly financing the manufacturing of commodities, paying salaries to workers and bearing the administrative costs. In *Murabahah,* the role of the bank is restricted just to the act of selling. Moreover, in Murabahah, the transaction would not be considered as legal unless the Islamic bank owns the commodity first before transferring it to the buyer. During this period of ownership of the commodity by the Islamic bank, there is a possibility of risk of damage or loss while in *Itisna'* the commodity will be transferred only after its completion.[42]

Finally, the difference between sale and istisna' is more obvious since in absolute sale there is no labor while in Itisna' it represents the cornerstone of the contract. Thus, it appears clear that the contract of *Itisna' is* not *Salam, or fu'alah, Ijarah*, or an ordinary contract of sale. It is an independent kind of contract with is own conditions. Moreover, it combines the distinctive traits of some of these contracts, such as:

(1) The distinctive traits of *Salam* as to its permissibility even though the subject-matter of the contract is not in existence at the time of the contract;

[42] See Ibid

(2) In addition, the distinctive trait of the ordinary sale whereby the price can be paid by installments or deferred and it is not necessarily to be advanced as in *Salam.*[43]

2.1.6.1 The specific legal basis of *Istisna'*

Muslim jurists have tried to establish the legality of this contract from different legal sources: the *Qur'an,* the *Sunnah, Ijma', Qiyas, Istihsan, and Maslahah.* However, *Istihsan* seems to represent the first legal basis for this contract especially in the literature of the classical schools of law. Al-Kasani in this regard said:

Concerning the legality of *Istisna'*, in principle it would not be allowed on the basis of *Qiyas* because it is a sale of what we do not have nor on the basis of *Salam* and the Prophet had prohibited the sale of what we do not have ... and it is allowed based on *Istihsan* because people are unanimous about its need. They have used it through the ages and the Prophet has said "My community shall never agree on an error" and "What is good for Muslims is good in the sight of Allah".[44]

It is also claimed that this contract is based on Ijma'. The claim of Ijma' by the Hanafis is widespread among the major Hanafi works, such as al-Mabsut and al-Badai'.

Regarding the basis of Istisna' under public interest (Maslahah), which refers to unrestricted public interest in the sense of not having been regulated by the lawgiver and no textual authority can be found on its validity or vice versa, l-Ashgar said: "The use of this contract, for example:

[43] See Ibid.
[44] See Kasani,*Badai al-Sana`i`fi Trtib al- Shara`,i,* Cairo, Sharikah al- Matbu`at al- Islamiyyah, (1910), vol.5, p.6

in building construction, shoes, furniture and other items without objections from the scholars is a demonstration of the general need. Therefore, it should be legal on the basis of public interest".

On the other hand, Siddiq al-Darir maintains that *Istisna'* is based on *Qiyas* and not against it as it is claimed by the Hanafis. He argues that although the subject-matter in this contract does not exist, its availability is certain, and there is no risk (gharar) especially in the opinion that *Istisna'* is a binding contract. Then it is a legal contract, and any contract free from excessive risk *(gharar}* is a contract in accordance with *Qiyas.*[45]

Besides, according to al-Ashgar the legality of this contract can be demonstrated by the Qur'anic guidance in the story of Zulqarnain where some people requested him to build a barrier between them and the Gog and Magog people (Surat al-Kahf 18:94). Commenting on this verse, Ibn Abbas said "kharajan" means big reward. According to al-Ashgar, this verse represents a guidance in the Qur'an for the legality of the contract of *Istisna'.*

But it seems that this agreement may have been concluded as a leasing contract or any other type of contract or even a pure charity. Therefore, the claim of considering it as evidence for the legality of Istisna' is hard to accept. On the other hand, this contract is also contended to be based on a Hadith that the Prophet had ordered the manufacture of a ring and a pulpit for himself. However nothing prove that the ring or the pulpit are made under *Istisna'*.[46]

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[45] Siddiq al-Darir, *al-Gharar fi al-Uqud wa Attaruhu fi al-Tatbiqat al-Muasirah,* IRTI,Jeddah,IDB,p.56

[46] See Muhammed Al-Bashir Muhammed Al-Amine *Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] pp 22-48

2.1.6.2 The binding effect of Istisna'

The classical Hanafi jurists generally divide the binding effect of this contract into three stages. At the first stage where the work of manufacturing has not yet started, the Hanafi jurists are unanimous that the contract is not binding (lazim) upon either of the parties and the manufacturer may refrain from making the commodity and both contracting parties have the right of revocation.[47] At the second stage, the manufacturer may finish making the needed goods, but the client has not seen the manufactured object yet. The manufacturer still has the right even to sell the commodity to a third party. The third stage is when the required goods have been manufactured and presented to the purchaser. Here, again the Hanafi jurists have different opinions whether the purchaser has a right to reject the commodity or not.

However, it is reported that Abu Yusuf is of the opinion that Istisna is binding from the first stage whereby no one has the right to revoke the contract, because otherwise the manufacturer will be harmed and it is possible that he will not find anyone who will buy the goods from him in time or he may not get a similar price as agreed upon with the first purchaser.[48]

Moreover, Article 392 of the Majella endorses this opinion and considers the contract of Istisna' as binding from the beginning. In addition, if we refer to the opinion of the contemporary Muslim jurists we realise that they follow the Majella provisicn. Furthermore, the practice in the Islamic banks is also based on this opinion. Thus, al-Tadamun Bank opted for this opinion by

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[47] See Kasani,*Badai al-Sana`i`fi Trtib al- Shara`,i,* Cairo, Sharikah al- Matbu`at al- Islamiyyah, Vol. 5, p. 680.
[48] . See, Zuhaili, Wahba Zuhaili, *al-Fiqh al-Islami Wa Adillatuh,* Dar al-Fikr, Damacus, 1989, Vol. 4, p. 634.

providing that: "This is the opinion which can go along with the circumstances and conditions of the modern time especially with the booming industries".[49]

2.1.6.3 Modes of application of Istisna

The Islamic bank can use Istisna' as a buyer by contracting with industrial and manufacturing institutions, or with any artisan to manufacture or construct for it some commodities with specific description. Then, it can sell them after receipt, for cash, installed or deferred payment through Murabahah or bay' bi al-Thaman al-'ajil. Thus, the Islamic bank will be involved in direct investment. But this method is related to some extent to the position of the Islamic bank where in practice some Islamic banks are not allowed to be involved directly in commerce.

It is also permissible for the bank to enter an Istisna' contract in the capacity of seller to those who demand the purchase of a particular commodity. Then, it will draw a parallel Istisna' contract in the capacity of a buyer with another party to make or manufacture the commodity agreed upon in the first contract. This method is more suitable to the practice of Islamic banks

The first Istisna' can be immediate or deferred and the payment in the second Istisna' can be cash or deferred as well. The parallel Istisna' is the most applicable form of Istisna'. Accordingly, the deal may involve three parties: firstly, the customer (the buyer); secondly, the Islamic bank (the seller); and finally, the original manufacturer. Sometimes, especially in building construction, it

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[49] See Muhammed Al-Bashir Muhammed Al-Amine. *Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] pp 22-48

may involve four parties; the customer; the Islamic bank (contractor); the subcontractor; and a consultant or an expert to supervise the execution of the construction contract.[50]

It is worth noting that the contract between the Islamic bank and the customer and the contract between the Islamic bank and the manufacturer or sub-contractor should be separate and independent from each other. Moreover, the Islamic bank should not wait for the coming together of two parties agreeing on the manufacture or construction of something, and proposing that the bank finances the project only because such a deal can no longer be an *Istisna'* but rather a loan with interest. This is because in such a deal the Islamic bank is just lending money to the seller for a determined profit.

It is necessary for the Islamic bank to set up its special unit on matters related to Istisna' having its own special relation with the manufacturers and constructors with whom it can bargain and contract on its own responsibility, sharing with them the risk, benefit, and bearing the liability of any defect in the manufactured or constructed commodity. Only in this way, it is possible to make the difference between a usurious (Ribawi) and interest-free investment. Furthermore, Islamic banks have their own objectives, which differ from the conventional bank; an alteration therefore, in the structure of the bank is necessary to fulfil this objective in a Shari' manner.[51]

Al Istisna al-tamwili, which is used by Islamic banks, consists of two separate *istisna* ` contracts. The first is concluded between the beneficiary and the bank, in which the price is payable by the purchaser in future, in agreed installments and the bank undertakes to deliver the requested

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[50] Ibid

[51] See The American Journal of Islamic Finance, 1997, Greenwich Hills Drive, USA, Spring 1997, Vol. VII, No. 1, p. 4.

manufactured commodity at an agreed time. The second istisna` contract is a subcontract concluded between the bank and a contractor to manufacture the product according to prescribed specifications. The bank would normally pay the price in advance or during the manufacturing process in installments. The latter undertakes to deliver the product to the bank on the date prescribed in the contract, which is the same date as that stated in the first *istisna* ` contract. The original purchaser (i.e., the bank's client) may be authorized to receive the manufactured commodity directly from the manufacturer.[52]

2.1.6.4 Shari'a Considerations of Istisna' Contract

1. It is important that the price or consideration is fixed between the two parties.[53]

2. The specifications of the commodity to be manufactured should be known for an *Istisna'* transaction to be valid

3. It is a condition in the *Istisna*' contract to state in the clearest of terms, the type, dimensions and all the specifications required because it is a condition in all commutative contracts the sold commodity must be known to avoid ignorance which leads to dispute.

4. *Istisna*' contract is valid for objects that can be made. It is invalid for all natural products whose sale on liability is a *Salam and not Istisna'* such as Corn, wheat, barley or fruit

5. Before the producer starts the manufacturing process, an *Istisna*' transaction simply creates a moral obligation between the producer and the client and the contract may be revoked by anyone of the two parties involved after giving a notice to the other.[54]

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[52] See Muhammed Al-Bashir Muhammed Al-Amine. Istisna' and Its Application in Islamic Banking Arab Law Quarterly, [2001] p 38

[53] See Kasib Abd al Karim, *Aqd al-Istisna fi al-Fiqh al-Islami* p.133

6. However, after the manufacturer has started the work, the Istisna' contract is binding to the two parties, and no party has the right to retract; only if the commodity does not conform to the specifications demanded, can the buyer have the option.[55]

7. It is a condition that the period of delivery is specified whether it is short or long so as to avoid ignorance which leads to conflict between the two parties. If the producer delays the delivery of the commodity after the set time limit, the client will not be required to accept the commodity or pay the set amount. In order to prevent the late delivery of commodities, a penalty levied on the producer may be calculated on a daily basis.

8. It is a condition that the place of delivery is (specified) stated if the commodity needs loading or transportation expenses.

9. The buyer may stipulate in the Istisna' contract that the commodity shall be manufactured or produced by a specific manufacturer, or manufactured from specific materials. This is not permitted in the case of Salam sale.

10. Article 392 of the Majallah provides that if the manufacturer brought the goods according to specification, the purchaser will be forced to accept them.[56]

2.1.6.5 **Areas of Application**

Istisna' contract is applied in high technology industries such as aircraft industry, locomotive and ship building industries, in addition to the different types of machines produced in the big factories or workshops. It is also applied in the construction industry such as apartment

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[54] See See Kasani,*Badai al-Sana`i`fi Trtib al- Shara`,i,* Cairo, Sharikah al- Matbu`at al- Islamiyyah,vol.5,p.3
[55] *Al-Mabsut*, vol.12, p.139
[56] *Mujallat al-Ahkam al-Adliyyah*-the civil code of Ottoman Empire- Article 392.

buildings, hospitals, schools, universities to whatever that makes the network of modern life. Istisna' contract is applicable to the various industries as long as one can be monitored by measurement and specifications such as the food processing industry.[57]

2.1.7 **Salam**

In Arabic, the word salam means to advance. This is a contract where by the purchaser pays the price in advance and the delivery of subject matter is postponed to a specific time in future.[58] Islamic banks can provide financing by way of a *salam* contract by entering into two separate *salam* contracts, or one *salam* contract and an installments sale contract. For example, the bank could buy a commodity by asking an advance payment to the supplier and fixing the date of delivery as the date desired by its client. It can then sell the commodity to a third party either on *a salam* or installments sale basis. If the two were *salam* contracts, the second contract would be for delivery of the same quantity, description, etc., as that constituting the subject-matter of the first *salam* contract. This second contract is often concluded after the first contract, as its price has to be paid immediately upon conclusion of the contract. To be valid from the *Shari `ah* point of view, the second contract must be independent, i.e., not linked to the delivery in the first contract. Should the second contract consist of an installments sale, its date should be subsequent to the date on which the bank would receive the commodity.[59]

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[57] See Muhammed Al-Bashir Muhammed Al-Amine. *Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] p. 40

[58] Mansoori,Dr.Muhammad Tahir, *Islamic Law of Contract and Business Transaction*, Shariah Academy, IIU, Islamabad p.200.

[59] See Ahmad Ausaf Dr. *Contemporary Practices of Islamic Financing Techniques*, IRTI,,Jedda Saudi Arabia,1413H, (1993)Research Paper No. 20 P.45

2.1.7.1 Moderen application of the Salam Contract:

Islamic banks and financial institutions use *salam* as a mode of financing. They finance the need of farmers who need money to grow their corps. They enter into an agreement with them for advance purchase pf agricultural product, specifying complete details of the commodity, its quality, price and time of delivery and make payment of the amount at the time of entering into the agreement. When the commodity is produced and supplied to the bank on the appointed date, they sell it at profit in the market.

The bank sometimes sells the commodity through a parallel contract of *salam*. The period in the second contract is shorter while the price is fixed a little higher than the price of the first transaction. Thus, they earn profit by the difference between two prices. There may be another way of benefiting from *salam*. The bank may obtain a promise to purchase from third party. This promise should be unilateral from the prospective buyer. Being merely a promise, and not an actual sale, the buyer will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the commodity is received by the institution it will be soled to the third party at a pre- agreed price according to the term of the promise.[60]

2.1.7.2 Shari'a Considerations of Salam Contract

1. It is necessary that the buyer pay the price of the object in full to the seller in advance. If the

[60] Taqi, Usmani,*An introduction to Islamic finance Idara tu-al- Marif Karachi,, p.194*

price os not paqid at the time of the contract, it will amount at sale of a debt for debt, which has been prohibited by the Holy prophet (s.a.w.s)[61]

2. For a *salam* contract to be valid, the commodity should be known. Ignorance about the commodity leads to dispute which invalidates the contract.

3. The specifications of the commodity to be sold must be well described to both the buyer and seller. Description should include all quality and quantity characteristics that affect its price leaving no ambiguity, which sometimes leads to disputes.

4. Subject should be something that is going to be produced or purchased by seller. If the good can be pinpointed at the time of contracting, then *salam* is not applicable. Therefore, a given automobile or a known building can never from Shari'a point of view be considered as a salam contract.

5. Price has to be determined, and must be paid in full to the seller at the time of the contract. If a bank wishes to release *salam* funds to a borrower according to the latter's production schedule, the bank should sign more than one separate *salam* contracts with the borrower, one for each stage of ending. The principal of each contract will be paid at the exact time of its conclusion.

6. The due date must be known to avoid ignorance, which may lead to dispute. Thus, the period of the duration of the contract must be specified, either as a date in the future or as a number of days, weeks or months.

7. It is a condition that the place of delivery is stated in the contract if the commodity needs loading or transportation expenses.

9. Buyer is not allowed to sell the goods brought before actual delivery "possession", because the *salam* commodity is a liability debt on the seller and not an existing commodity. Instead of that,

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[61] Shawkani,*Naylal-Awtar*, , Cairo, dar al-Fikr, vol 5 p.165

it is permissible for the buyer to draw a parallel *salam* contract without connecting it to the first *Salam* contract, as discussed before.[62]

10. It is permissible to take mortgage and guarantor on *salam* debt to guarantee that the seller satisfies his obligation by delivering the commodity sold, which is a liability on the due date.

10. The probability of the existence of the commodity at the time of delivery must be high; if the contrary is the case, *salam* is impermissible.

11. The buyer is not allowed to enjoy ownership rights over the purchased goods before taking them into his possession. Thus, he cannot sell them or make them a partnership capital, unless he takes over the goods.[63]

2.1.7.3 **Areas of Application**

Salam sale is suitable for the finance of agriculture operations, where the bank can transact with farmers who are expected to have the commodity in plenty during harvest either from their own crops or crops of others, which they can buy and deliver in case their crops fail. The *salam* sale is applied by the bank in financing craftsmen and small producers by supplying them with inputs of production as a *salam* capital in exchange of some of their commodities to remarket. *Salam* sale is also used to finance the commercial and industrial activities, especially phases prior to production and export of commodities and that is by purchasing it on *salam* and marketing them

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[62] See Muhammed Al-Bashir Muhammed Al-Amine. Istisna' and Its Application in Islamic Banking Arab Law Quarterly, [2001] pp-46-48

[63] Zuhayli Wahba Zuhali,,*al-Fiqh al- Islamiwa Adillatuhu*,vol.4 p.560

for lucrative prices.

The following example shows how *salam* can be used in international trade.

Example: Pre-shipment Export Finance: This is undertaken in the following steps.

1. Bank receives an export letter of credit (LC) in favor of its client, covering certain goods; client gives the letter of credit under bank's lien. Thus, allowing the bank to assume the role of seller to the foreign buyer.

2. To comply with the LC requirement, bank agrees to buy the goods from its client under a *salam* contract and makes upfront payment to him. *Salam* contract devised for this purpose should include specific delivery date and place. Delivery date should be reasonably ahead of the latest shipment date stated in the letter of credit.

3. As for the place, it should be the port of destination mentioned in the LC. Submission of in-order shipping documents (viz. bill of lading and certificate of origin) by the client may be deemed equivalent to the satisfactory delivery.

4. The agreed payment (pre-shipment finance) made by the bank to its client will be lower than the amount of the export LC, difference being bank's profit.[64]

2.2 NATURE OF RISK FACED BY ISLAMIC BANKS AND FINANCIAL INSTITUTIONS

The risk profile of an Islamic bank is almost similar to the conventional interest based bank.

[64] See Muhammed Al-Bashir Muhammed Al-Amine. *Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] pp-49

However, the Islamic banks face two types of risks. The first type of risks they have in common with conventional banks such as credit risk, market risk, liquidity risk and operational risk. But due to specificities of the Islamic banks the nature of these risks may changes. The second type is of new and distinctive risks that the Islamic banks face as a result of their unique asset and liability structures. Consequently the processes and techniques of risk identification and management available to the Islamic banks could be set into two types standard techniques. The first set of techniques which are similar to those of conventional framework and not in conflict with the Islamic peinciples of finance and the second set of techniques which are new or adapted and are supposed to meet the Islamic law.[65]

2.2.1. Types of risks similar to the conventional and Islamic banks could be set as follows:

2.2.1.1 Credit Risk:

Credit Risk happens when the counterparty fails to meets its obligation timely and fully in accordance with the agreed terms. It is the risk of loss due to the other party defaulting on contracts or obligations[66]

Credit risk would take the form of settlement/payment risk arising when one party to a deal pays money (e.g. in a *Salam* or *Istisnā'*contract) or delivers assets (e.g., in a *Murābahah* contract)

[65] See BEN ARAB Mounira, Managing Risks and Liquidity in an Interest Free Banking Framework, International Journal of Business and Management, Vol.3, No.9, p.85)

[66] See Tariqullah khan and Ahmad Risk Management an analysis of issues in Islamic financial industry Occasional paper 5, 1422H (2001),IRTI-IDB Jeddah Saudi Arabia, p.28.

before receiving its own assets or cash, thereby, exposing it to potential loss. In case of profit-sharing modes of financing (like *Mudārabah* and *Mushārakah*) the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due. This problem may arise for banks in these cases due to the asymmetric information problem in which they do not have sufficient information on the actual profit of the firm. As *Murābahah* contracts are trading contracts, credit risk arises in the form of counterparty risk due to nonperformance of a trading partner. The nonperformance can be due to external systematic sources. This can lead not only to an increase in the liquidity crises but also declines the quality of the bank assets.

This problem may arise for Islamic banks especially when there is a problem of a asymmetry of information. The uncertain honesty of the enterprenure and his misdirected use of funds can lead banks into difficulty.the prohibition of interest does not not permit Islamic banks to postpone debts on the basis of a re-negotiated higher mark-up rate. This can provide an incentive to their dishonest client to default, thereby exposing these banks to additional credit risk.[67]

2.2.1.2 Benchmark Risk (Market Risk):

The risk of adverse deviations of the mark level prices or rates of assets and liabilities due to the market factors, economic changes or external events. Islamic banks take up "Risk sharing" funds, whereas conventional banks take "capital certain" deposits where repayment must be made. There is the implicit requirement for both parties to a given transaction to share in the loss

[67] See BEN ARAB Mounira, Managing Risks and Liquidity in an Interest Free Banking Framework, International Journal of Business and Management, Vol.3, No.9, p.86)

as well as the profit.[68]

As Islamic banks do not deal with interest rate, it may appear that they do not have market risks arising from changes in the interest rate. Changes in the market interest rate, however, introduce some risks in the earnings of Islamic financial institutions. Financial institutions use a benchmark rate, to price different financial instruments. Specifically, in a *Murābahah* contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the LIBOR). The nature of fixed income assets is such that the mark-up is fixed for the duration of the contract. As such if the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result Islamic banks face risks arising from movements in market interest rate. [69]

2.2.1.3 **Liquidity Risk:**

As mentioned above, liquidity risk arises from either difficulties in obtaining cash at reasonable cost from borrowings or sale of assets. The liquidity risk arising from both sources is critical for Islamic banks. As interest based loans are prohibited by *Sharī'ah,* Islamic banks cannot borrow funds to meet liquidity requirement in case of need. Furthermore, *Sharī'ah* does not allow the sale of debt, other than its face value. Thus, to raise funds by selling debt-ased assets is not an option for Islamic financial institutions.

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[68] See BEN ARAB Mounira, *Managing Risks and Liquidity in an Interest Free Banking Framework*, International Journal of Business and Management, Vol.3, No.9, p.86)

[69] See Ashadi Zain, *Islamic Finance-Risk Management. Does Islamic Finance reject the concept of Risk Management* Article Version: 3 last edited: Aug 8, 2008 12:30 am p.21.

2.2.1.4 **Operational Risk:**

Operational risk is the risk that arises from human error and/or deficiencies in information systems, internal process or controls, resulting in direct or indirect loss. In the Islamic banking context, operational risks can impact just as much as in conventional banking, with the additions element of possible operational defects causing failure to comply with the Islamic laws.

Also given the newness of Islamic banks, operational risk in terms of person risk can be acute in these institutions. Operational risk in this respect particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic financial operations. Given the different nature of business the computer software available in the market for conventional banks may not be appropriate for Islamic banks. This gives rise to system risks of developing and using informational technologies in Islamic banks.[70]

2.2.1.5. **Exchange Risk**

This risk refers to the adverse exchange rate movements on foreign currency positions taken by

[70] See BEN ARAB Mounira, *Managing Risks and Liquidity in an Interest Free Banking Framework*, International Journal of Business and Management, Vol.3, No.9, p.87)

the bank which causes suffering losses. According to the Islamic teaching, currency transactions on a deferred basis are not permissible. Trading of currencies wherever undertaken by an Islamic bank is on a spot basis Letter of credit and trade finance for example often poses an exchange risk[71].

2.2.2 Risk specific to Islamic banks

Risk is legitimate when it is necessary for value creating. But when no value is added, it is a form of gambling. To be accepted in an Islamic view, the risk shall be inevitable and thus inseparable from real value adding transactions.

Islamic banks face other types of risks different from those encountered by their conventional counterparts due to specific requirements to comply with the Islamic teachings.

2.2.2.1 **Commodities and inventory risk:**

This type of risk arises from holding items in inventory either for resale under Murabaha contract, or with a view of leasing under an ijara contract. In a murabaha contract the client has a right to change his mind and may decide not to go ahead with the transaction. It's probable that the client may go back on his terms in the Murabaha or ijara contracts which will introduce an element of risk in the transaction. Once this latter found, the bank will be responsible for the charge. In ijara contract, Islamic bank is exposed to the risk on the residual value of the leased

[71] Ibid

asset at the term of the lease or if the client terminates the lease earlier (by defaulting), during the contract.[72]

2.2.2.2 **Rate of return risk:**

Rate of return risk differs from interest rate risk in that Islamic banks are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly. This may increase responsibility in managing their investment deposit holders' expectations and their liabilities to current account holders.

A consequence of rate of return risk may be the displaced commercial risk which arises from the probability of the bank not being able to compete with other Islamic or conventional banks. Therefore, the Islamic bank may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by Profit Loss Sharing deposit holders when the return on assets is under-performing as compared with competitors' rates.[73]

2.2.2.3 **Legal and Islamic laws compliance risk**

Given the different nature of financial contracts, Islamic banks face risks related to their

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[72] See Tariqullah khan and Ahmad *Risk Management an analysis of issues in Islamic financial industry* Occasional paper 5, 1422H (2001),IRTI-IDB Jeddah Saudi Arabia, p.31

[73] See BEN ARAB Mounira, *(Managing Risks and Liquidity in an Interest Free Banking Framework*, International Journal of Business and Management, Vol.3, No.9, p.80)

documentation and enforcement. As there are no standard form of contracts for various financial instruments, Islamic banks prepare these according to their understanding of the Sharī'ah, the local laws, and their needs and concerns. Lack of standardized contracts along with the fact that there are no litigation systems to resolve problems associated with enforceability of contracts by the counterparty increases the legal risks associated with the Islamic contractual agreements.

In many countries where Islamic banks coexist with conventional banks, there is a pressure to apply to the same regulation for both types of banks and a common legal framework is generally developed. No separate regulatory laws have yet been set to govern the operations of Islamic banks, which have been trying to benefit from the support that the conventional framework can provide, except those countries which have their whole financial system Islamized with an Islamic central bank. Islamic banks are more exposed to the risk of changes in government fiscal and monetary policies than the conventional banks as they participate in profit –and-loss of the business enterprises. They are also exposed to reputational risk arising from negative publicity about the Islamic banks' business practices, particularly relating to non-compliance to Islamic laws in their products and services, could have an impact upon their market position, profitability and liquidity.[74]

2.2.2.4 **Equity position risk in the banking book**

[74] See Ashadi Zain, *Islamic Finance-Risk Management. Does Islamic Finance reject the concept of Risk Management* Article Version: 3 Last edited: Aug 8, 2008 12:30 am

Risk inherent in the holding of equity instruments for investment purposes, In particular, for Islamic bank, the relevant instruments are typically those based on the Mudarabaha and Musharakah contracts. A consequence of the equity position risk is the fiduciary risk which is resulting from the management of investment accounts. This type of risk refers to the probability of the bank being guilty of negligence or misconduct in implementing the deposit, investors' funds, through mudaraba or Musharaka contracts. Such legal liability would expose the bank to direct losses associated with breach of its fiduciary responsibility toward its depositors as well as indirect losses resulting from the decline in the market price of its listed shares. The depositors may, as a result, loss confidence in the bank and withdraw their deposits.[75]

2.2.2.5 **Withdrawal Risk:**

A variable rate of return on saving/investment deposits introduces uncertainty regarding the real value of deposits. Asset preservation in terms of minimizing the risk of loss due to a lower rate of return may be an important factor in depositors' withdrawal decisions. From the bank's perspective, this introduces a 'withdrawal risk' that is linked to the lower rate of return relative to other financial institutions. In order to increase the public's confidence on the Islamic banks, the interests of depositors and other users of financial services need to be protected.[76]

2.2.2.6 **Fiduciary Risk:**

A lower rate of return than the market rate also introduces fiduciary risk, when depositors/investors interpret a low rate of return as breaching of investment contract or

[75] See BEN ARAB Mounira, *Managing Risks and Liquidity in an Interest Free Banking Framework*, International Journal of Business and Management, vol.3, No.9, p.84)
[76] Ibid

mismanagement of funds by the bank[77]. Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to fully comply with the Sharīʻah requirements of various contracts. While, the justification for the Islamic banks' business is compliance with the Sharīʻah, an inability to do so or not doing so willfully can cause a serious confidence problem and deposit withdrawal.

2.2.2.7 Displaced Commercial Risk

This risk is the transfer of the risk associated with deposits to equity holders. This arises when under commercial pressure banks forgo a part of profit to pay the depositors to prevent withdrawals due to a lower return[78] Displaced commercial risk implies that the bank though may operate in full compliance with the *Sharīʻah* requirements, yet may not be able to pay competitive rates of return as compared to its peer group Islamic banks and other competitors. Depositors will again have the incentive to seek withdrawal. To prevent withdrawal, the owners of the bank will need to apportion part of their own share in profits to the investment depositors.[79]

[77] AAOIFI (1 999(a), "Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks", Bahrain: Accounting and Auditing Organization for Islamic Financial Institutions.
[78] Ibid
[79] See BEN ARAB Mounira, Managing Risks and Liquidity in an Interest Free Banking Framework, International Journal of Business and Management, vol.3, No.9, p.84

UNIQUE COUNTERPARTY RISKS OF ISLAMIC MODES OF FINANCE

In this section I will discuss some of the risks inherent in Islamic modes of financing.

2. 3.1. Murābahah Financing

Murābahah is the most predominantly used Islamic financial contract. If the contract is standardized its risk characteristics can be made parable to interest-based financing. Based on similarity in risk characteristics of the contract with the risk characteristics of interest-based contracts, *Murābahah* is approved to be an acceptable mode of finance in a number of regulatory jurisdictions. However, such a standardized contract may not be acceptable to all *Fiqh* scholars. Moreover, as the contract stands at present, there is a lack of complete uniformity in *Fiqh* viewpoints. The different viewpoints can be a source of counterparty risks as a result of the atmosphere of an ineffective litigation.

The main point in this regard stems from the fact that financial *Murābahah* is a contemporary contract. There is a complete consensus among all *Fiqh* scholars that its validity is based on the fact that the bank must buy (become owner) and after that transfer the ownership right to the client. The order placed by the client is not a sale contract but it is merely a promise to buy. [80]

[80] See Sunil Kumar Dr Academic Article: *Risk management in murabaha*, 01 April, 2008 p.5

Maliki jurists regard promises as binding, the Hanafi jurists also favor the concept of the binding nature of the promises.[81] According to the Islamic *Fiqh* Academy Resolution,[82] a promise can be binding on one party only. Islamic *Fiqh* Academy and most Islamic banks treat the promise to buy as binding on the client. Some other Jurists like Shafi and Hanbali, however, are of the opinion that the promise is not binding on the client it is just a moral obligation, the client even after putting an order and paying the commitment fee can rescind from the contract[83]. The most important counterparty risk specific to *Murābahah* arises due to this unsettled nature of the issue that weather the promise is binding on the promisor or not, which can pose litigation problems.

Another potential problem in a sale-contract like *Murābahah* is late payments by the counterparty as Islamic banks cannot, in principle, charge anything in excess of the agreed upon price. Nonpayment of dues in the stipulated time by the counterparty implies loss to banks.[84]

The activities which make up a *murabaha* contract pass through several important phases/stages, each of which has different risk implications. The process generally starts with (1) Customer identifying the commodity he/she wishes to acquire through bank financing.(2) The Islamic Financial Institution is then approached by the customer for financing. (3) The commodity is acquired by the IFI, (4) which subsequently sells it to the customer after adding its profit margin, (5)he customer tan repay the installments of murabaha to the bank as per repayment schedule agreed upon by the parties. The IFI is exposed to different risks in each stage of this process.

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[81] Ibn Juzy,*al-Qawanin al-Fiqhiyyah*,p.258

[82] Resolution No.2 and 3, Islamic Fiqh Academy, See Academy's Journal No.5, vol.2, p.1509.

[83] Ibn Qudamah,al- *Mughani,*vol,4, p.17

[84] See Tariqullah khan and Ahmad *Risk Management an analysis of issues in Islamic financial industry* Occasional paper 5.IRTI-IBD, Jeddah Saudi Arabia 1422H(2001) p.57

The four main types of risk associated with a murabaha contract are: credit risk, market risk, Operational risk and liquidity risk:

i. Between stages 2 and 3, the IFI faces the risk of the customer refusing to honor his commitment to buy, thus it is exposed to market risk through any fluctuation in the price of the underlying commodity.

ii. Between stages 3 and 4, the IFI is further exposed to market risk via the downward movement in the price of the underlying commodity. The IFI is also exposed to the operational risk incurred in holding the commodity (as a result of damage, spoilage, theft etc.) for the period in which it is in its possession. If the IFI delays delivery it exposes itself further to market and operational risk.

iii. Between stages 4 and 5, the IFI is exposed to credit risk linked to potential default or delayed payments from the customer, as well as to liquidity risk resulting from changes in the anticipated cash flow.

The relationship between the IFI and the customer also keeps changing at various stages, namely from promisee–promisor in stages 1/2, to seller–buyer in stages 3/4 and, finally, to debtor–creditor in stages 4/5.[85]

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[85] Dr Sunil Kumar Academic Article: *Risk management in Mmurabaha*, 01 April, 2008 p.5

2.3.2. Salam Financing

There are at least **two important counterparty risks in *Salam***. A brief description of these risks is provided here.

i. The counterparty risks can range from **failure to supply on time** or even at all, and failure to supply the same quality of good as contractually agreed. Since *Salam* is an agricultural based contract, the counterparty risks may be due to factors beyond the normal credit quality of the client. For example, the credit quality of the client may be very good but the supply may not come as contractually agreed due to natural calamities. Since agriculture is exposed to catastrophic risks, the counterparty risks are expected to be more than normal in *Salam*.

ii. All *Salam* contracts end up in physical deliveries and ownership of commodities. These commodities require inventories exposing the banks to **storage costs and other related price risk**. Such costs and risks are unique to Islamic banks. Since "selling what one does not have" is generally unacceptable on grounds of gharar, the above structure does not permit the bank to sell X before taking delivery of the same. Thus, the bank would need to wait till time of actual

delivery before it can get back its investment and profits. This at times may not be very desirable, given the financial position of the bank. Another problem with the simplified structure is the price risk that the bank is now exposed to. It is quite possible that price of the commodity declines during the first and second time period to a level below resulting in losses to the bank..[86]

2.3.3. Specific counterparty risks in the contract of Istisna.

While extending *Istisnā'* finance the bank exposes its capital to a number of specific counterparty risks. These include for example:

i. The counterparty risks under *Istisnā'* faced by the bank from the supplier's side are similar to the risks mentioned under *Salam*. There could be a **contract failure regarding quality and time of delivery**. However, the object of *Istisnā'* is more in the control of the counterparty and less exposed to natural calamities as compared to the object of *Salam*. Therefore, it can be expected that the counterparty risk of the sub-contractor of *Istisnā'* although substantially high, is lesser severe as compared to that of the *Salam*.

ii. The default risk on the buyer's side is of the general nature, namely, failure in paying fully on time.

iii. If the *Istisnā'* contract is considered optional and not binding as the fulfillment of conditions

[86] See Tariqullah khan and Ahmad *Risk Management an analysis of issues in Islamic financial industry* by occasional paper 5,IRTI-IDB, Jeddah Saudi Arabia 1422H(2001) p.57.

under certain *Fiqhī* jurisdictions may need, there is a counterparty risk as the supplier maintains the option to rescind from the contract.

iv. Considering that like the client in the Murābahah contract, if the client in the Istisnā'contract is given the option to rescind from the contract and decline acceptance at the time of delivery, the bank will be exposed to additional risks.

These risks exist because, an Islamic bank while entering into an Istisna' contract assumes the role of a builder, a constructor, a manufacturer and supplier. Since the bank does not specialize in these traits, it relies on subcontractors.[87]

2.3.4 ***Mushārakah - Mudārabah*** **(M-M) Financing**

Many academic and policy oriented writings consider that the allocation of funds by the Islamic banks on the basis of the *Mushārakah* and *Mudārabah* is preferable as compared to the fixed return modes of *Murābahah*, leasing and *Istisnā'*. But in practice the Islamic banks' use of the Musharakah-Mudarabah modes is minimal. This is considered to be due to the very high credit risk involved. The credit risk is expected to be high under the M-M modes due to the fact that there is no collateral requirement, there is a high level of moral hazard and adverse selection and banks' existing competencies in project evaluation and related techniques are limited. Institutional arrangements such as tax treatment, accounting and auditing systems, regulatory

[87] Ibid

framework are all not in favor of a larger use of these modes by banks.[88]

2.3.5 Ijara Financing

It is very important for the Islamic bank to bear a certain amount of risk in order that its profits are deemed legitimate in the eyes of *Shari'a*. All the risk and liabilities emerging from the ownership of the asset are to be borne by the lessor (bank) while the liabilities arising from the use of the leased assets are to be borne by the lessee (customer). In Islamic leasing or *ijara*, the leased asset remains in the risk of the lessor throughout the *ijara* period, in the sense that any loss, damage or loss caused by the factors beyond the control of the lessee shall be borne by the lessor. The lessor has to bear two types of risk:

i. **Market risk:** In a true leasing business, the lessor acquires the lease asset prior to securing any leasing contracts. Thus the lease asset is subject to price risk, the risk that the lessor is not able to profitably lease out the asset

ii. **Operational risk:** Maintenance costs can sometimes exceed rental income thereby resulting in a loss to the lessor. Hence, from a *Shari'a* perspective, one critical factor in determining the permissibility of any *ijara* arrangement is whether the lessor actually bears risks expected of a true lessor (ownership risks and maintenance costs).

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[88] Ibid

iii **Default Risk:** *Ijara* rental, like *murabaha* installment becomes a debt on the customer after it becomes due. Therefore, it is subject to all the rules prescribed for defaults and delinquencies in repayment of debt.[89]

2.4 RISK PERCEPTIONS

In this section, I well report some perspectives of Islamic bankers regarding the risks that their institutions face. Te discussion is based on the presentation of Khan and Ahmed (2001). They present a survey of risk management of 17 Islamic financial institutions in 10 countries and rank risk perceptions.[90]

2.4.1. Overall Risks faced by Islamic Financial Institutions

Table 4.1 reports the average rankings of different kinds to risks faced by Islamic banks. Note that the rank has a range of 1 to 5, the former indicating "Not serious" and the latter implying "Critically Serious". It appears that Islamic bankers rank the mark-up (interest rate) risk as the most critical risk they face (3.07) followed by operational risk (2.92), and liquidity risk at 2.71. While credit risk is the risk that most FIs deal with, they do not rank this risk as severe as these risks (2.71). Among the risks listed, Islamic FIs consider market risk to be the least risky (2.50).

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[89] See Marine Money, *To Lease or not to Lease: Ijara as a Viable Ship Financing Structure,* Asia Edi Tion-Vol. 3, p.4.

[90] See Tariqullah khan and Ahmad *Risk Management an analysis of issues in Islamic financial industry* occasional paper 5,IRTI-IDB, Jeddah Saudi Arabia 1422H(2001) p.47.

The reasons for considering mark-up risk the highest may be that Islamic debt contracts (like *Murabahah)* cannot be repriced and cannot use swaps to transfer this risk. Operational risk may have been ranked high because given the new nature of Islamic banking a lot of the issues related to the operations need to be instituted. These include training of employees, creating computer programs and legal documents, etc. Liquidity risk is also ranked higher than credit risk due to the lack of money market instruments to manage liquidity. One reason of a relatively low credit risk may be that with asset or commodity based financing that most Islamic FIs use, this risk is minimized as the asset/commodity serves as collateral.

Table 2.4.1

Risk Perception-Overall Risks Faced by Islamic Financial Institutions

	Number of Relevant Responses	Average Rank*
Credit Risk	14	2.71
Mark-up Risk	15	3.07
Liquidity Risk	16	2.81
Market Risk	10	2.50
Operational Risk	13	2.92

*The rank has a scale of 1 to 5, with 1 indicating 'Not Serious' and 5 denoting 'Critically Serious'.

Market risk is incurred on instruments like commodities and equities traded in well-traded markets appears to be least risky. This risk arising from movements in the prices of

goods/securities are usually a part of the trading book of a bank. On the banking book, conventional banks trade in bonds to keep a part of their assets in liquid money-market instruments. As the majority of the *Shari 'ah* scholars forbid the sale of debt, trading in bonds almost nonexistent in Islamic FIs. Islamic banks, however, can trade in commodities and assets backed securities. The later securities are scant, leaving only trading in commodities that can be as a source of market risk for Islamic FIs. As not too many banks are involved in commodity trading, this may be a reason for a low ranking of market risk by Islamic FIs.

2.4.2. Risks in Different Modes of Financing

Table 4.2 reports the Islamic bankers' viewpoints on different kinds of risks inherent in various Islamic modes of financing. The results of these risks are discussed below.

Table 2.4.2

Risk Perception-Risks in different Modes of Financing

	Credit	**Mark-up Risk**	**Liquidity**	**Operational**
Murabahah	2.56 (16)	2.87 (15)	2.67 (15)	2.93 (14)
Mudarabah	3.25 (12)	3.0 (11)	2.46 (13)	3.08 (12)
Musharakah	3.69 (13)	3.4 (10)	2.92 (12)	3.18 (11)
Ijarah	2.64 (14)	2.92 (12)	3.1 (10)	2.9 (10)
Istisna'	3.13 (8)	3.57 (7)	3.0 (6)	3.29 (7)
Salam	3.20 (5)	3.50 (4)	3.20 (5)	3.25 (4)
Diminishing	3.33	3.4	3.33	3.4

Musharakah	(6)	(5)	(6)	(5)

Note: The numbers in parentheses indicates the number of respondents.

*The rank has a scale of 1 to 5, with 1 indicating 'Not Serious' and 5 denoting 'Critically Serious.

2.4.2.1 Credit Risk

Credit risk appears to be the least in *Murabahah* (2.56) and the most in *Musharakah* (3.69) followed by diminishing *Musharakah* (3.33) and *Mudarabah (3.25).* It appears that profit-sharing modes of financing are perceived to have higher credit risk by the bankers. Note that credit risk in case of profit-sharing modes of financing arises if the counterparties do not pay the banks their due profit-share. Furthermore, this amount if not known to banks *ex ante. Ijarah* ranks as second (2.64) after *Murabahah* as having the least credit risks. Like the *Murabahah* contract, *Ijarah* contract gives the banks a relatively certain income and the ownership of the leased asset remains with the bank. *Istisna'* and *Salam* ranked at 3.13 and 3.20 respectively are relatively more risky. These product-deferred modes of financing are perceived to be riskier than price-deferred sale *(Murabahah).* This may arise as the value of the product (and hence the return) at the end of the contract period is uncertain. There are chances that the counterparty may not be able to deliver the goods on time. This may arise to different reasons like natural disasters (for commodities in a *Salam* contract) and production failure (for products in *Istisna'* contract). Even if the good is delivered, there can be uncertainty regarding the price of the good upon delivery affecting the rate of return.

The results on credit risk give some insight to the composition of instruments in Islamic banks. We have noted earlier, Islamic banks' assets are concentrated in fixed-income assets (like *Murabahah* and *Ijarah).* The results from the survey indicate that one explanation for the concentration of assets in fixed income assets may be that these instruments are perceived as having the least credit risk among the Islamic modes of financing. As banks business is to take up and manage credit risks, Islamic banks do not opt for other profit-sharing modes of financing (like *Mudarabah* and *Musharakah)* as they regard these instruments to be relatively more risky.

2.4.2.2 Mark-up Risk

Table 4.2 shows that mark-up risk ranked highest in terms of severity in product-deferred contracts of *Istisna'* (3.57) and *Salam (3.5),* followed by profit-sharing modes of financing of *Musharakah* and diminishing *Musharakah* (ranked at 3.4) and *Mudarabah* (3.0){ Mark-up risk can appear in profit sharing modes of financing like *Mudarabah* and *Musharakah* as profit-sharing ratio depends on, among others, a benchmark rate like LIBOR}. *Murabahah* is considered to have the least mark-up risk (2.87) followed by *Ijarah (2.92).* Mark-up (interest rate) risk tends to be higher in long-term instruments with fixed rates. One reason for higher concern of mark-up risk in *Istisna'* may be that these instruments are usually of long-term nature. This is particularly true for real estate projects. The contracts are tied up to a certain mark-up rate and changes in the interest rate expose these contracts to risks. *Murabahah* shows the least risk as this mode of financing is usually short-term. After *Murabahah, Ijarah* is conceived to have relatively less mark-up risk. Even though *Ijarah* contracts may be of long-term, the return (rent)

on these contracts can be adjusted to reflect market conditions. Among the profit-sharing modes of financing, the Islamic bankers rank *Musharakah* and diminishing *Musharakah* relatively higher as these are usually longer-term engagements. *Mudarabah* is usually used for short-term financing and has a lower mark-up risk than these two instruments.

2.4.2.3 Liquidity Risk

Liquidity risk of instruments will be smaller if the assets can be sold in the markets and/or have short-term maturity. The bankers consider *Mudarabah* to have the least liquidity risk (2.46) followed by *Murabahah (2.67).* Note that both of these instruments are usually used for short term financing. Other instruments are perceived as relatively more risky, with diminishing *Musharakah* showing the highest liquidity risk (with a rank of 3.33) and product-deferred instruments of *Salam* and *Istisna'* closely following at 3.2 and 3.0 respectively. *Ijarah* is also perceived to have a relatively higher liquidity risk (3.1).

2.4.2.4 Operational Risk

As mentioned above, operational risk can arise from different sources. Some aspects relevant to operational risk in Islamic banks are the legal risk involved in contracts, the understanding of the modes of financing by employees, producing computer programs and legal documents for different instruments, etc. The rankings showing the operational risk for different instruments should include these concerns. It appears that operational risk is lower in fixed income assets of *Murabahah* and *Ijarah* (2.93 and 2.9 respectively) and one of the highest in product-deferred

sale contracts of *Salam* and *Istisna'* (3.25 and 3.29). Profit-sharing modes of financing of *Mudarabah* and *Musharakah* follow close with ranks of 3.08 and 3.18 respectively. Operational risk is highest in diminishing *Musharakah (3.4).* The relatively higher rankings of the instruments indicate that banks find these contracts complex and difficult to implement.[91]

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[91] Ibid

3. RISK MANAGEMENT: BASIC CONCEPTS AND TECHNIQUES

In this chapter I well discuss the concept of risk management from the Holy Quran, Sunnah and Aqal (mind). After explaining the basic risk concepts and techniques related to risk management, I well describe the risk management process. Risk management process is a comprehensive system that includes creating an appropriate risk management environment, maintaining an efficient risk measurement, mitigating, and monitoring process, and establishing an adequate internal control arrangement. After outlining the basic idea of the risk management process and system, 1 well discuss the management process for specific risks related to Islamic modes of financing.

3.1. The Concept of Risk Management in Islamic Finance

Risk management is a concept that is not only accepted by Islam, but embraced as one of the ways to ensure the fulfillment of goals and objectives, that ultimately should arrive at *saâadah* (happiness) in this world and the hereafter. This is proven by numerous *Quranic* verses and Prophetic traditions that encourage mankind to use his *aql* (mind) to excel in a world of uncertainties. Although in Islamic finance, the concept of *al-ghurm bil ghunm* (no risk, no gain) is prevalent, it does not mean that Islam is against risk management. In actual fact, Islam is against the two extremes of risk taking behaviour, i.e. risk avoidance (taking no risk with an expectation to make gains), and taking excessive risk, which is evident in transactions that contain the element of *maisir* (gambling). What Islam promotes is the act of taking calculated risks, with the expectation to make gains.[1]

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[1] See Ashadi Zain ,*Islamic Finance-Risk Management- Does Islamic Finance reject the concept of Risk Management*, Article Version: 3, Last edited, Aug 3, 2008.

There are many examples from the *Quran* and the *Sunnah* on the practice of managing risks. For instance, in Surah Yusuf,[2] we are told about the story of Prophet Yusuf a.s., where in one occasion, he interpreted the dream of the King of Egypt, i.e. Egypt will be facing seven years of drought after seven years of prosperity. Based on this interpretation, Prophet Yusuf a.s. then recommended a plan to face such a catastrophe, i.e. for the people of Egypt to actively plant crops during the first seven years and store much of the proceeds. This is to prepare themselves to face the seven years of drought, as foreseen by him. The Prophet was then appointed by the King to be the Minister of Agriculture. As the Minister of Agriculture, he implemented his own recommendation, as endorsed by the King, resulting in the country surviving the seven years of drought. This is a clear example of risk management, whereby the risk of hunger and famine is mitigated by planting crops and eatables during the seven years of prosperity. Another example from the Holy Quran is Prophet Yaqoob while advising his childeren "O my children, do not enter the capital of Egypt by one gate but go into it by different gates. However, know it well that I cannot ward off you Allah's will for none other than He has nay authority whatsoever. In Him I have put my trust and all who want to rely upon anyone should put their trust in Him alone."[3]

Example from *hadith*[4] that is frequently used by the proponents of takaful. In a *hadith* narrated by Amer bin Ummiyah, who asked Prophet (peace be upon him) should I leave my camel untied and trust in God? The Prophet PBUH said, tie up your camel first then put your trust in God." This indicates that although the outcome of any action is determined by God alone, we must always use our *aql* to determine the best course of action, with the condition that it does not contravene the *Shariâah*. In the risk management context, in this case, the risk of the camel running away or stolen is mitigated by tying it.

[2] Al Quran (Surah Yusuf: Verses 43-49)
[3] Al Quran (Surah Yusuf: Verse 67)
[4] Abubakar Al Baihiqai, Shuab ul Eman by H.# 1 09

From the evidence or *dalil* that is shown above, it is clear that Islam does not reject the concept of risk management but find it necessary for the continuing existence of mankind as the vicegerent on Gods lovely earth.

3.2. What is risk management?

Risk arises when there is a possibility of more than one outcome and the ultimate outcome is unknown. Risk can be defined as the variability or volatility of unexpected outcomes. Well, basically risk is uncertainty and exposure to that uncertainty. It is usually measured by the standard deviation of historic outcomes. Though all businesses face uncertainty, financial institutions face some special kinds of risks given their nature of activities.

In a nutshell, Risk management can be summarized as the process of identifying risks, measuring risks, monitoring risks, risk reporting and controlling risks. Thus, with the definitions given, it is clear that a financial system cannot operate in an efficient and effective manner without the existence of a sound and robust risk management system, particularly in this current globalized world, where systemic risks are at the back of everyone mind, especially the CEOs of large financial institutions, with offices all over the world. The objective of financial institutions is to maximize profit and shareholder value-added by providing different financial services mainly by managing risks.[5]

3.3. Classification of Risk

There are different ways in which risks are classified. One way is to distinguish between business risk and financial risks[6]. Business risk arises from the nature of a firm's business. It relates to factors affecting the product market. Financial risk arises from possible losses in

[5]Ashadi Zain, Islamic Finance-Risk Management: Does Islamic Finance reject the concept of Risk Management Article Version: 3, List edited: Aug 8, 2008.

[6] Oldfield,G.and Santamero,A.(1997). Risk management in financial institutions,Sloan managemet review,39(1),PP.33-46

financial markets due to movements in financial variables.[7] It is usually associated with leverage with the risk that obligations and liabilities cannot be met with current assets.[8] Another way of decomposing risk is between systematic and unsystematic components. While systematic risk is associated with the overall market or the economy, unsystematic risk is linked to a specific asset or firm. While the asset-specific unsystematic risk can be mitigated in a large diversified portfolio, the systematic risk is non diversifiable. Parts of systematic risk, however, can be reduced through the risk mitigation and transferring techniques.

To understand the underlying principle of risk management, we use Oldfield and Santomero (1997) classification of risks. Accordingly, financial institutions face the following three types of risks: risks that can be eliminated, those that can be transferred to others, and the risks that can be managed by the institution. Financial intermediaries would avoid certain risks by simple business practices and will not take up activities that impose risks upon them. The practice of financial institutions is to take up activities in which risks can be efficiently managed and shift risks that can be transferred. Risk avoidance techniques would include the standardization of all business-related activities and processes, construction of diversified portfolio, and implementation of an incentive-compatible scheme with accountability of actions. Some risk that banks face can be reduced or eliminated by transferring or selling these in well-defined markets. Risk transferring techniques include, among others, use of derivatives for hedging, selling or buying of financial claims, changing borrowing terms, etc.

There are, however, some risks that cannot be eliminated or transferred and must be absorbed by the banks. The first is due to the complexity of the risk and difficulty to separate it from asset. The second risk is accepted by the financial institutions as these are central to their business. These risks are accepted because the banks are specialized in dealing with them and get

[7] Jorion, Phillippe and Sarkis J. Khoury (1996). Financial Risk Management Domestic and International Dimensions, Blackwell Publishers, Cambridge, Massachusetts , p. 2). Sources: Kan and Ahmad (2001, paper-5)

[8] Gleason, James T. (2000), Risk: The New Management Imperative in Finance, Bloomberg Press, Princeton, New Jersey., p. 21 Sources: Kan and Ahmad (2001, paper-5)

rewarded accordingly. Examples of these risks are the credit risk inherent in banking book activities and market risks in the trading book activities of banks.[9]

3.4. Risk measurement and Risk management

There is a difference between risk measurement and risk management. While risk measurement deals with quantification of risk exposures, risk management refers to "the overall process that a financial institution follows to define a business strategy, to identify the risks to which it is exposed, to quantify those risks, and to understand and control the nature of risks it faces"[10] Before we discuss the risk management process and measurement techniques, we give an overview of the Major Risks faced by financial institutions and the evolution of risk management.

3.5 Risk Management: The Process and system

Though main elements of risk management include identifying, measuring, monitoring, and managing various risk exposures, these cannot be effectively implemented unless there is a broader process and system in place. The overall risk management process should be comprehensive embodying all departments/sections of the institution so as to create a risk management culture. It should be pointed out that the specific risk management process of individual financial institutions depends on the nature of activities and the size and sophistication of an institution. A comprehensive risk management system should encompass the following **three components**. These three components are derived from BCBS's recommendations of managing specific risks.[11] Before discussion of these components the following general

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[9] Tariqullah Khan and Ahmad Risk Management an analysis of issues in Islamic financial industry occasional paper 5, Jeddah Saudi Arabia 1422H(2001)

[10] Cumming, Christine and Beverly J. Hirtle (2001), "The Challenges of Risk Management in Diversified Financial Companies", Economic Policy Review, Federal Reserve Bank of New York, p. 3. Sources: Kan and Ahmad (2001, paper-5)

[11] BCBS (1999- Principles for the Management of Credit Risk, Consultative Paper and BCBS-

requirements shall also be taken into account which issued by SBP as Draft Risk Management guidelines for Islamic Banking institution based on the IFSB standard of guiding principles on Risk Management,

These Risk Management Guidelines provide a set of best practices for establishing and implementing effective risk management in IBIs. The principles contained in these Guidelines are designed to complement the current risk management principles issued by the 'Basel Committee on Banking Supervision' (BCBS) and other international standard-setting bodies:

3.5.1. Establishing Appropriate Risk Management Environment and Sound Policies and Procedures

This stage deals with the overall objectives and strategy of the bank towards risk and its management policies. The board of directors is responsible for outlining the overall objectives, policies and strategies of risk management for any financial institution. The overall risk objectives should be communicated throughout the institution. Other than approving the overall policies of the bank regarding risk, the board of directors should ensure that the management takes the necessary actions to identify, measure, monitor, and control these risks. The board should periodically be informed and review the status of the different risks the bank is facing through reports. Senior management is responsible to implement these broad specifications approved by the board. To do so, the management should establish policies and procedures that would be used by the institution to manage risk. These include maintaining a risk management review process, appropriate limits on risk taking, adequate systems of risk measurement, a comprehensive reporting system, and effective internal controls.

Procedures should include appropriate approval processes, limits and mechanisms designed to assure the bank's risk management objectives are achieved. Banks should clearly identify the

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Principles for the Management and Supervision of Interest Rate Risk 2001b).

individuals and/or committees responsible for risk management and define the line of authority and responsibility. Care should be taken that there is adequate separation of duties of risk measurement, monitoring and control functions. Furthermore, clear rules and standards of participation should be provided regarding position limits, exposures to counterparties, credit and concentration. Investment guidelines and strategies should be followed to limit the risks involved in different activities. These guidelines should cover the structure of assets in terms of concentration and maturity, asset-liability mismatching, hedging, securitization, etc.[12]

3.5.2 Maintaining an Appropriate Risk Measurement, Mitigating, and Monitoring Process

Banks must have regular management information systems for measuring, monitoring, controlling and reporting different risk exposures. Steps that need to be taken for risk measurement and monitoring purposes are establishing standards for categorization and review of risks, consistent evaluation and rating of exposures. Frequent standardized risk and audit reports within the institution are also important. The actions needed in this regard are creating standards and inventories of risk based assets, and regularly producing risk management reports and audit reports. The bank can also use external sources to assess risk, by using either credit ratings, or supervisory risk assessment criterion like CAMELS.(define it) Risks that banks take up must be monitored and managed efficiently. Banks should do stress testing to see the effects on the portfolio resulting from different potential future changes. The areas a bank should examine are the effects of downturn in the industry or economy and market risk events on default rates and liquidity conditions of the bank. Stress testing should be designed to identify the conditions under which a bank's positions would be vulnerable and the possible responses to such situations. The banks should have contingency plans that can be implemented under different scenarios.

[12] Ibid

3.5.3 Adequate Internal Controls

Banks should have internal controls to ensure that all policies are adhered to. An effective system of internal control includes an adequate process for identify and evaluating different kinds of risks and having sufficient information systems to support these. The system would also establish policies and procedures and their adherence are continually reviewed. These may include conducting periodic internal audits of different processes and producing regular independent reports and evaluations to identify areas of weakness. An important part of internal control is to ensure that the duties of those who measure, monitor, and control risks are separated. Finally, an incentive and accountability structure that is compatible with reduced risk taking on part of the employees is also an important element to reduce overall risk. A prerequisite of these incentive-based contracts is accurate reporting of the bank's exposures and internal control system. An efficient incentive compatible structure would limit individual positions to acceptable levels and encourage decision makers to manage risks in a manner that is consistent with the banks goals and objectives.

3.6 General Requirement for Risk Management Process

IBIs shall have in place a comprehensive risk management and reporting process, including appropriate board and senior management oversight, to identify, measure, monitor, report and control relevant categories of risks. The process shall take into account appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority

3.6.1 Board of directors (BOD) and senior management oversight

3.6.1.1. As with any financial institution, the risk management activities of IBIs require active oversight by the BOD and senior management. The BOD shall approve the risk management objectives, strategies, policies and procedures that are consistent with the IBIs' financial condition, risk profile and risk tolerance. Such approvals shall be communicated to all levels in the IBI involved in the implementation of risk management guidelines.

3.6.1.2. The BOD shall ensure the existence of an effective risk management structure for conducting IBI's activities, including adequate systems for measuring, monitoring, reporting and controlling risk exposures.

3.6.1.3. IBIs shall have in place a Shariah Advisor, in accordance with sound principles of corporate governance and SBP's Fit and Proper Criteria for Shariah Advisors, to oversee that IBIs' products and activities comply with Shariah rules and principles as advised by SBP and Shariah Advisor

3.6.1.4. The BOD shall approve limits on aggregate financing and investment exposures to avoid concentration of risk and ensure that IBIs hold adequate capital against these exposures. The BOD shall review the effectiveness of the risk management activities periodically and make appropriate changes as and when necessary.

3.6.1.5. Senior management shall execute the strategic direction set by the BOD on an ongoing basis and set clear lines of authority and responsibility for managing, monitoring and reporting risks. The senior management shall ensure that the financing and investment activities are within the approved limits.

3.6.1.6. Senior management shall ensure that the risk management function should be separated from risk review function and is reporting directly to the BOD or senior management outside the risk-taking unit. Depending on the scope, size and complexity of IBI's business activities, the risk management function is carried out by personnel from an independent risk management unit. These personnel shall define the policies, establishes procedures, monitor compliance with the established limits and report to top management on risk matters accordingly.

3.6.1.7. IBIs shall have a sound process for executing all elements of risk management, including risk identification, measurement, mitigation, monitoring, reporting and control. This process requires the implementation of appropriate policies, limits, procedures and effective management with the scope, complexity and nature of IBIs' activities.

3.6.1.8. IBIs shall ensure that an adequate system of controls with appropriate checks and balances is in place. The controls shall (a) comply with the Shariah rules and principles; (b) comply with applicable regulatory and internal policies and procedures; and (c) take into account the integrity of risk management processes.

3.6.1.9. IBIs shall make appropriate and timely disclosure of information to depositors having deposits on Profit and Loss Sharing basis, minimum requirements of which are specified by SBP in its Guidelines for Shariah Compliance in IBIs", so that they are able to assess the potential risks and rewards of their deposits and to protect their own interests in their decision making process.[13]

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[13] See Isamic Financial Services Board (2005) Guiding Principles of Risk Management For Institutions (Other Than Insurance Institutions) offering only Islamic Financial Services (IIFS)-Kula-Lumpur, Malaysia, and Draft Risk Management guidelines for Islamic Banking institution State Bank of Pakistan,,Islamic Banking Department www.sbp.org.pk

3.7 Management Processes of Specific Risks

As mentioned above the total risk of an asset can be assigned to different sources. Given the general guidelines of risk management process above, in this section we give details of risk management processes for specific risks faced by banks.

3.7.1 Credit Risk Management

Before discussion of credit risk management process the following SBP risk management guidelines in relation to the credit Risk Management should be complied with.

i. IBIs shall have in place a strategy for financing, using various instruments in compliance with Sharī'ah, whereby they recognize the potential credit exposures that may arise at different stages of the various financing agreements.

ii. IBIs shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

iii. IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

iv. IIFS shall have in place Sharī'ah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.[14]

The board of directors should outline the overall credit risk strategies by indicating the bank's willingness to grant credit to different sectors, geographical location, maturity, and profitability. In doing so it should recognize the goals of credit quality, earnings, growth, and the risk-reward tradeoff for its activities. The credit risk strategy should be communicated throughout the institution.

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[14] Draft Risk Management guidelines for Islamic Banking institution State Bank of Pakistan,,Islamic Banking Department www.sbp.org.pk

The senior management of the bank should be responsible to implement the credit risk strategy approved by the board of directors. This would include developing written procedures that reflect the overall strategy and ensure its implementation. The procedures should include policies to identify, measure, monitor, and control credit risk. Care has to be given to diversification of portfolio by setting exposure limits on single counterparty, groups of connected counterparties, industries, economic sectors, geographical regions, and individual products. Banks can use stress testing in setting limits and monitoring by considering business cycles, interest rate and other market movements. Banks engaged in international credit need to assess the respective country risk.

Banks should have a system for ongoing administration of various credit risk-bearing portfolios. A proper credit administration by a bank would include an efficient and effective operation related to monitoring documentation, contractual requirements, legal covenants, collateral, etc., accurate and timely reporting to management, and compliance with management policies and procedures and applicable rules and regulations.

Banks must operate under sound, well-defined credit-granting criteria to enable a comprehensive assessment of the true risk of the borrower or counterparty to minimize the adverse selection problem. Banks need information on many factors regarding the counterparty to whom they want to grant credit. These include, among others, the purpose of the credit and the source of repayment, the risk profile of the borrower and its sensitivity to economic and market developments, borrowers repayment history and current capacity to repay, enforceability of the collateral or guarantees, etc. Banks should have a clear and formal evaluation and approval process for new credits and extension of existing credits. Each credit proposal should be subject to careful analysis by a credit analyst so that information can be generated for internal evaluation and rating. This can be used for appropriate judgments about the acceptability of the credit.

Granting credit involves accepting risks as well as producing profits. Credit should be priced so that it appropriately reflects the inherent risks of the counterparty and the embedded costs. In considering the potential credit, the bank needs to establish provisions for expected loss and hold adequate capital to absorb the unexpected losses. Banks can use collateral and guarantees to help mitigate risks inherent in individual transactions. Note, however, that collateral cannot be a substitute for comprehensive assessment of a borrower and strength of the repayment capacity of the borrower should be given prime importance.

Banks should identify and manage credit risk inherent in all of its assets and activities by carefully reviewing the risk characteristics of the asset or activity. Special care is needed particularly when the bank embarks on new activities and assets. In this regard, adequate procedures and controls need to be taken to identify the risks in new asset or activity. Banks must have analytical techniques and information systems to measure credit risk in all on- and off balance sheet activities. The system should be able to provide information on sensitivities and concentrations in the credit portfolio. Banks can manage portfolio issues related to credit through loan sales, credit derivatives, securitization, and involvement in secondary loan markets.

Banks must have a system for monitoring individual credits, including determining the adequacy of provisions and reserves. An effective monitoring system would provide the bank, among others, the current financial condition of the counterparty. The system would be able to monitor projected cash-flow and the value of the collateral to identify and classify potential credit problems. While monitoring the overall composition and quality of the portfolio, a bank should not only take care about the concentrations with respect to counterparties activities but also the maturity.

Banks should develop internal risk rating systems to mange credit risk. A well-structured internal rating system can differentiate the degree of credit risk in different credit exposures of a bank by

categorizing credits into various gradations in risk. Internal risk ratings are important tool in monitoring and controlling credit risk as periodic ratings enable banks to determine the overall 36 characteristics of the credit portfolio and indicates any deterioration in credit risk. Deteriorating credit can then be subject to additional monitoring and supervision.

A bank should have independent ongoing credit reports for the board of directors and senior management to ensure that the bank's risk exposure is maintained within the parameters set by prudential standards and internal limits. Banks should have internal controls to ensure that credit policies are adhered to. These may include conducting periodic internal audits of the credit risk processes to identify the areas of weakness in the credit administration process. Once the problem credits are identified, banks should have a clear policy and system for managing problem credits. The banks should have effective workout programs to manage risk in their portfolio.[15]

3.7.1.1. Default issues and payment safeguards.

Leniency towards debtors can be abused and it is often difficult to distinguish between those who cannot meet their obligations through no fault of their own and unscrupulous defaulters who will not pay. There are potential moral hazard problems in Islamic finance, and those who would take advantage of any perceived leniency by Islamic banks. Shari'ah-compliant contracts assume a degree of trust between the parties, who should be governed by a higher moral authority. Peer pressure can make borrowers acknowledge their responsibilities, as with microfinance, and if all those involved in Islamic finance feel they are part of a community with shared religious values this should help ensure compliance with contractual obligations.

[15] This section is based on the credit risk management process discussed in BCBS (1999), Principles for the Management of Credit Risk, Consultative Paper, Basel Committee on Banking Supervision, July 1999.

Credit risk is the most important risk faced by banks, because defaults can also trigger liquidity, interest rate, downgrade and other risks. Therefore, the level of a bank's credit risk adversely affects the quality of its assets in place. Therefore, Effective risk management is a core banking challenge, and any failure by Islamic banks could threaten not only their reputation, but also potentially that of the entire Shari'ah-compliant financial services sector.

A number of standard systems, methods, and procedures for credit risk mitigation as GAP analyses, value at risk, Risk adjusted rate of return, Risk adjusted rate of return (PARCO), internal rating etc.are also relevant for the Islamic banks. In addition, there is also a need to keep in view the unique situation of these banks.[16] A number of additional considerations are discussed here in relation to the credit risk management of Islamic banks.

a. Importance of Expected Loss Calculation

The process of credit risk mitigation involves estimating and minimizing expected credit losses. Calculation of expected credit losses requires the calculation of probability of default, maturity of facility, loss given default, exposure at default and the sensitivity of the assets' value to systematic and nonsystematic risks. Expected loss calculation is relatively easier for simple and homogenous contracts as compared to relatively complex and heterogeneous contracts. Since the Islamic financial contracts are relatively complex as compared to the interest-based credit, the accurate calculation of expected losses is supposed to be relatively challenging for the Islamic contracts. The lack of consensus in dealing with a defaulter, illiquid nature of debts etc., add to the complexity of this matter. This challenge can be overcome by adapting the foundation IRB approach. Although most Islamic banks already use some form of internal rating systems, it is

[16] See Credit risk management in Islamic Finance, Based on Professor Wilson's presentation at the IIBI's monthly lecture, London, March 2007. Rodney Wilson, Durham University, 01 April, 2007

early for the Islamic banks to qualify for the IRB approach for regulatory capital allocation. Nevertheless, the presence of some form of internal ratings in these banks implies they can enhance their systems with an objective to gradually qualify for the IRB approach. If that happens, these banks will be expected to initially follow the supervisory benchmark LGD and the risk weights. Gradually, the banks can develop their own systems of calculating the LGD and can graduate to the advanced IRB approach.

b. Loan Loss Reserves

Sufficient loan loss reserves offer protection against expected credit losses. The effectiveness of these reserves depends on the credibility of the systems in place for calculating the expected losses. Recent developments in credit risk management techniques have enabled large traditional banks to identify their expected losses accurately. The Islamic banks are also required to maintain the mandatory loan loss reserves subject to the regulatory requirements in different jurisdictions. However, as discussed above the Islamic modes of finance are diverse and heterogeneous as compared to the interest-based credit. These require more rigorous and credible systems for expected loss calculation. Furthermore, for comparability of the risks of different institutions there is also a need for uniform standards for loss recognition across modes of finance, financial institutions and regulatory jurisdictions. The ***AAOIFI Standards # 1*** provides for the basis of income and loss recognition for the Islamic modes of finance. However, except for a few institutions, banks and regulatory organizations do not apply these standards. In addition to the mandatory reserves some Islamic banks have established investment protection reserves.

c. Collateral

Collateral is also one of the most important security against credit loss. Islamic banks use collateral to secure finance, because *al-rahn* (an asset as a security in a deferred obligation) is

allowed in the *Sharī'ah*. According to the principles of Islamic finance, a debt due from a third party, perishable commodities and something, which is not protected by the Islamic law as an asset, such as an interest-based financial instruments are not eligible for use as collateral. On the other hand, cash, tangible assets, gold, silver and other precious commodities, share in equities, etc., and debt due from the finance provider to the finance user are assets eligible for collateral.

d. **Guarantees**

Guarantees supplement collateral in improving the quality of credit. Commercial guarantees are extremely important tools to control credit risk in conventional banks. Those banks whose clients can provide good commercial guarantees and who can fulfill other requirements can qualify for regulatory capital relief under the proposed New Basel Accord. Although some Islamic banks also use commercial guarantees, the general *Fiqh* understanding goes against their use. In accordance with the *Fiqh*, only a third party can provide guarantees as a benevolent act and on the basis of a service charge for actual expense .

e. **Internal Ratings**

All banks undertake some form of internal evaluation and rating of their assets and clients, particularly, for maintaining the regulatory loan loss provisions, in a general sense an internal rating system can be described to be a risk-based inventory of individual assets of a bank. These systems identify credit risks faced by the banks on an asset-toasset basis in a systematic and planned manner instead of looking at bank's risk on an entire portfolio basis. The asset-to-asset coverage of the system makes it more relevant for banks whose asset structures are less homogenous. The Islamic modes of finance are diverse and have different risk characteristics. For example, a credit facility extended to a BBB rated client on the basis of *Murābahah, Istisnā'*, leasing and *Salam* will have different not uniform risks exposures. The risk exposure is expected

to be different not only across modes of finance but also across clients. For example, if there are two clients both rated as BBB, due to the different nature of the businesses of the two clients, risk exposure of the same mode can be different for the different clients. In addition, different maturity can have different implication for risk across modes and across clients. Therefore, due to the diversity of the Islamic modes of finance, it is appropriate for the Islamic banks to measure the risk of each asset separately. Developing a system of internal ratings can be instrumental in doing this. Various banks use different systems. For establishing a basic internal rating system in a bank, two basic information are required - maturity of the facility and credit quality of the client. Maturity of facility is known in all cases of funding. Credit quality of the client can be assessed by various means. The client may have a previous record with the bank, it may be rated by rating agencies and it must have audited reports. Moreover, the general reputation of the client, and the type of collateral provided can also be helpful. Putting all these and other relevant information together wherever available, bank staff can judgmentally assess the clients' credit quality. Once this information is available, each client can be assigned an expected probability of default.

3.7.2 Interest Rate Risk Management

The board of directors should approve the overall objectives, broad strategies and policies that govern the interest rate risk of a bank. Other than approving the overall policies of the bank regarding interest rate risk the board of directors should ensure that the management takes the necessary actions toidentify, measure, monitor, and control these risks. The board should periodically be informed and review the status of interest rate risk the bank is facing through reports.

Senior management must ensure that the bank follows policies and procedures that enable the management of interest rate risk. These include maintaining an interest rate risk management

review process, appropriate limits on risk taking, adequate systems of risk measurement, a comprehensive interest rate risk reporting system, and effective internal controls. Banks should be able to identify the individuals and/or committees responsible for interest rate risk management and define the line of authority and responsibility.

Banks should have clearly defined policies and procedures for limiting and controlling interest rate risk by delineating responsibility and accountability over interest rate risk management decisions and defining authorized instruments, hedging strategies and position taking opportunities. Interest rate risk in new products should be identified by carefully scrutinizing the maturity, repricing or repayment terms of an instrument. The board should approve new hedging or risk management strategies before these are implemented.

Banks should have a management information system for measuring, monitoring, controlling and reporting interest rate exposures. Banks should have interest rate risk management systems that assess the effects of rate changes on both the earnings and economic value. These measurement systems should be able to utilize generally accepted financial concepts and risk management techniques to assess all interest risk associated with a bank's assets, liabilities, and off-balance sheet positions. Some of the techniques for measuring a bank's interest risk exposure are GAP analysis, duration, and simulation. Possible stress tests can be undertaken to examine the effects of changes in the interest rate, changes in the slope of the yield curve, changes in the volatility of the market rates, etc. Banks should consider the "worse case" scenarios and ensure that apropriate contingency plans are available to tackle these situations.

Banks must establish and enforce a system of interest rate risk limits and risk taking guidelines that can achieve the goal of keeping the risk exposure within some self-imposed parameters over a range of possible changes in interest rates. An appropriate limit system enables the control and monitoring of interest rate risk against predetermined tolerance factors. Any violation of limits should be made known to senior management for appropriate action.

Interest rate reports for the board should include summaries of the bank's aggregate exposures, compliance with policies and limits, results of stress tests, summaries of reviews of interest rate risk policies and procedures, and findings of internal and external auditors. Interest rate risk reports should be in details to enable senior management to assess the sensitivity of the institution to changes in the market conditions and other risk factors.

Banks should have adequate system of internal controls to ensure the integrity of their interest rate risk management process and to promote effective and efficient operations, reliable financial and regulatory reporting, and compliance with relevant laws, regulations, and institutional policies. An effective system of internal control for interest rate risk includes an adequate process for identify and evaluating risk and having efficient information systems to support these. The system would also establish policies and procedures and their adherence are continually reviewed. These periodic reviews would cover not only the quantity of interest rate risk, but also the quality of interest rate risk management. Care should be taken that there is adequate separation of duties of risk measurement, monitoring and control functions.[17]

3.7.3 Liquidity Risk Management

According to the draft risk management guidelines of SBP the following principal should be followed for liquidity risk management:

i. IBIs shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts and unrestricted investment accounts.

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[17] This section is based on the interest rate risk management process discussed in BCBS (2001b), *Principles for the Management and Supervision of Interest Rate Risk*, (Basel: Basel Committee on Banking Supervision).

ii. IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to Sharī`ah-compliant funds to mitigate such risk.

As banks deal with other people's money that can be withdrawn, managing liquidity is one of the most important functions of the bank. The senior management and the board of directors should make sure that the bank's priorities and objectives for liquidity management are clear. Senior management should ensure that liquidity risk is effectively managed by establishing appropriate policies and procedures. A bank must have adequate information system to measure, monitor, control and report liquidity risk. Regular reports on liquidity should be provided to the board of directors and senior management. These reports should include, among others, the liquidity positions over particular time horizons.

The essence of liquidity management problem arises from the fact that there is a trade-off between liquidity and profitability and mismatch between demand and supply of liquid assets. While the bank has no control over the sources of funds (deposits), it can control the use of funds. As such, a bank's liquidity position is given priority in allocating funds. Given the opportunity cost of liquid funds, banks should make all profitable investments after having sufficient liquidity. Most banks now keep protective reserves on top of planned reserves. While the planned reserves are derived from either regulatory requirements or forecasts, the amount of the protective reserve depends on the management's attitude towards liquidity risk.

Liquidity management decisions have to be undertaken by considering all service areas and departments of the bank. Liquidity manager must keep track and coordinate the activities of all departments that raise and use funds in the bank. Decisions regarding the banks liquidity needs must be analyzed continuously to avoid both liquidity surplus and deficit. In particular, the

liquidity manager should know in advance when large transactions (credit, deposits, withdrawals) would take place to plan effectively for resulting liquidity surpluses or deficits.[18] A bank should establish a process of measuring and monitoring net funding requirements by assessing the bank's cash inflows and outflows. The bank's off-balance sheet commitments should also be considered. It is also important to assess the future funding needs of the bank. An important element of liquidity risk management is to estimate a bank's liquidity needs. Several approaches have been developed to estimate the liquidity requirements of banks. These include the sources and uses of funds approach, the structure of funds approach, and the liquidity indicator approach.13 A maturity ladder is a useful device to compare cash inflows and outflows for different time periods. The deficit or surplus of net cash flows is a good indicator of liquidity shortfalls and excesses at different points in time.

Unexpected cash flows can arise from some other sources. As more and more banks are engaged in off-balance sheet activities, banks should also examine the cash flows on this account. For example, contingent liabilities used in these accounts (like financial guarantees and options) can represent substantial sources of outflows of funds. After identifying the liquidity requirements, a series of worse case scenarios can be analyzed to estimate both possible bank specific shocks and economy-wide shock. The bank should have contingency funding plans of handling the liquidity needs during these crises. Possible responses to these shocks would include the speed with which assets can be liquidated and the sources of funds that banks can use in the crisis. If the bank is dealing with foreign currency, it should have a measurement, monitoring and control system for liquidity in active currencies.

Banks should have adequate internal controls over its liquidity risk management process that should be a part of the overall system of internal control. An effective system would create a

[18] The discussion on Liquidity Risk Management is derived from BCBS (2000), *Sound Practices for Managing Liquidity in Banking Organizations* (Basel: Basel Committee on Banking Supervision).

strong control environment and have an adequate process of identifying and evaluating liquidity risk. It should have adequate information system that can produce regular independent reports and evaluations to review adherence to established policies and procedures. The internal audit function should also periodically review the liquidity management process to identify any problems or weaknesses for appropriate action by the management.[19]

3.7.4 Operational Risk Management

The board of directors and senior management should develop the overall policies and strategies for managing operational risk. As operational risk can arise due to failures in people, processes, and technology, management of this risk is more complex. Senior management needs to establish the desired standards of risk management and clear guidelines for practices that would reduce operational risks. In doing so, care needs to be taken to include people, process, and technology risks that can arise in the institution.

Given the different sources in which operational risk can arise, a common standard for identification and management of these needs to be developed. Care needs to be taken to tackle operational risk arising in different departments/organizational unit due to people, process, and technology. As such a wide variety of guidelines and rules have to be spelled out. To do so, the management should develop an 'operational risk catalogue' in which business process maps for each business/ department of the institution are outlined. For example, the business process for dealing with client or investor should be laid out. This catalogue will not only identify and assess operational risk but also can be used for transparency by the management and auditors.

Given the complexity of operational risk, it is difficult to quantify it. Most of the operational risk measurement techniques are simple and experimental. The banks, however, can gather information of different risks from reports and plans that are published within the institution (like

[19] See Rose, Peter S (1999), Commercial Bank Management, New York, McGraw-Hill

audit reports, regulatory reports, management reports, business plans, operations plans, error rates, etc.). A careful review of these documents can reveal gaps that can represent potential risks. The data from the reports can then be categorized into internal and external factors and converted into likelihood of potential loss to the institution. A part of the operational risk can also be hedged. Tools for risk assessment, monitoring, and management would include periodic reviews, stress testing, and allocation of appropriate amount of economic capital.

As there are various sources of operational risk, it needs to be handled in different ways. In particular, risk originating from people needs effective management, monitoring, and controls. These include establishing an adequate operating procedure. One important element to control operational risk is to have clear separation of responsibilities and to have contingency plans. Another significant element is to make sure that reporting systems are consistent, secure, and independent of business. The internal auditors play an important role in mitigating operational risk.[20]

3.8 Counter Party Risk Management Process in Islamic Modes of Finance

Credit risk, market risk, operational risk and liquidity risk are all interlinked, interrelated, and interwoven and are highly time-specific in the Shari'ah-compliant contracts. Several steps are required to address these risks, including risk identification, measurement, mitigation, and management.

3.8.1. Risk Management process in Murabaha Financing

In murabaha, before the client takes delivery, the IFI faces market risk as well as credit risk.

[20] This part is based on BCBS (1998), Operational Risk Management, Basel Committee on Banking Supervision, September 1998, and Crouhy, Michel, Dan Galai, and Robert Mark (2001), Risk Management, McGraw Hill, New York, Chapter 13.

Then, as the customer takes delivery and starts making murabaha payments, the IFI is exposed to credit risk and liquidity risk as a result of the credit risk. The dynamism of risk exposure through the life of the contract is unique to Islamic finance. Risk management in Islamic finance needs a clear time-line, showing the relational changes taking place between the parties to the contract. It warrants special treatment in the form of breaking down the contract life-span into identifiable phases and managing the risk differently in each phase.

Risk in murabaha should be considered within the wider context and should be dealt with on an integrated basis rather than in isolation. It would be inappropriate to manage each risk separately. For example, in order to cover market risk, the IFI may have a higher mark-up, which may in turn mean that the customer is unable to pay the installment, so exposing the IFI to credit and liquidity risk. Similarly, when the market price falls significantly, it creates a disincentive for the customer to continue to make payments thus exposing the IFI to credit and liquidity risk vis-a-vis the market.

There are several ways of handling risk in *murabaha* contracts:

- To cover the operational risk related to customer binding, the IFI can take collateral from the customer;
- To cover other operational risks related to possession in the intervening period, Shari'ah-permitted insurance can be used;
- To cover any potential payment default, a guarantee or a mortgage can be used;
- To cover the commodity price risk, the IFI can use dynamic simulation to create scenarios for future commodity prices and can use optimised prices for mark-up;
- Liquidity risk exposure can be covered by properly managing the other risks. The IFI is also able to estimate the cash flows associated with the murabaha contract more accurately, thus reducing the liquidity risk.

Murabaha is a transitory mode and not full profit and loss sharing mode like musharakah. Shari'ah scholars generally do not encourage the long-term use of murabaha. According to many Shari'ah experts, murabaha should be used only as a stop-gap. Because of its fixed cash-flow pattern, however, murabaha is preferred by IFIs over other contracts such as musharakah and mudarabah which do not offer a fixed cash-flow pattern. One disturbing trend is the use of murabaha for financing non-commodity needs, such as holidays, house renovations and other similar financial needs which fall under the grey definition of commodities. Although very popular, murabaha should be used judiciously and IFIs should reduce their dependence on it.[21]

3.8.1.1 Default Risk and Its Mitigation

A major problem associated with *murabaha* financing relates to a possibility of default by customers. In the case of default or delinquency, the conventional financial system penalizes the borrower with additional interest, which is deemed as a compensation for the delay or time value of money. Since the amount of compensation is determined with reference to the interest rate it is deemed to be a case of the prohibited riba. Hence, such practices are not allowed in case of *murabaha*. Selling price of *murabaha* transaction cannot be increased after contract concluded. Unscrupulous debtors may deliberately delay or avoid payment to exploit this. The issue is whether banks can impose a penalty in the event of delinquency in payment. As far as dealing with the problem of delays and delinquencies, various alternatives have been suggested.

1. One alternative is to require the customer-in-default to donate a specified amount for a charitable purpose as financial penalty. Such a penalty does not form part of the income of the bank and hence, does not compensate the bank either partially or fully for its cash flow problems caused by delays and delinquencies. It merely acts as a disincentive.
2. Another view suggests that customers who default in payment deliberately may be made liable to pay compensation to the bank for the loss. However, there should be additional

[21] See Dr Sunil Kumar , Risk management in Murabaha, Academic Articles, 01 April, 2008 p.6)

safeguards to ensure that the default is indeed willful and deliberate. In practice, many Islamic banks charge their customers some fees for the delay of payments as a service charge, attributable to additional services and allocated overhead costs that otherwise would not have been incurred.

3. A third alternative that is suggested is for the bank to stipulate a condition in the contract that in the event of payment default of a single installment that is due, the remaining installments will become due immediately. However, this alternative may cause undesirable hardships for the customer and has a lesser acceptance among bankers.
4. A fourth alternative to minimize default risk is for the bank to seek a security from its customer either in the form of a mortgage or in the form of a lien or a charge on any of his/her existing assets. The bank can also ask the customer to furnish a guarantee from a third party. In case of default in the payment of price at the due date, the bank may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him.The bank may also ask its customer to sign a promissory note or a bill of exchange.
5. Yet another alternative is to impose only non-financial penalty such as imprisonment, or defamation. Solvent defaulter should be dealt with punishment, rather than compensation.[22]

3.8.2 Risk Management Process in Mushārakah - Mudārabah (M-M) Financing

Many academic and policy oriented writings consider that the allocation of funds by the Islamic banks on the basis of the *Mushārakah* and *Mudārabah* is preferable as compared to the fixed return modes of *Murābahah*, leasing and *Istisnā'*. But in practice the Islamic banks' use of the M-M modes is minimal. This is considered to be due to the very high credit risk involved[23].The credit risk is expected to be high under the M-M modes due to the fact that there is no collateral requirement, there is a high level of moral hazard and adverse selection and banks' existing

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[22] See Ashadi Zain Islamic Finance-Risk Management-Does Islamic Finance reject the concept of Risk Management Article Version: 3 [illegible] Aug [illegible] 2008.

[23] Credit risk in context of these modes is similar to the common notion of not receiving the funds back on time or fully.

competencies in project evaluation and related techniques are limited. Institutional arrangements such as tax treatment, accounting and auditing systems, regulatory framework are all not in favor of a larger use of these modes by banks.

One possible way to reduce the risks in profit sharing modes of financing is for Islamic banks to function as universal banks. Universal banks can hold equity along with loans. In case of Islamic banks this would imply financing using *Mushārakah* mode. Before investing in projects on this basis, however, the bank needs to do a thorough feasibility study. By holding equity positions, universal banks can essentially get involved in the decision-making and management of the firm. As a result, the bank will be able to monitor the use of funds by the project more closely and reduce the moral hazard problem.

Some economists however, argue that banks by not opting for these modes are actually not benefiting from portfolio diversification and hence taking more risks rather than avoiding risks. Moreover, the use of M-M modes on both sides of the banks' balance sheets will actually enhance systemic stability as any shocks on the asset side will be matched by an absorption of the shock on the deposit side. It is also argued that incentive compatible contracts can be formulated which can reduce the effect of moral hazard and adverse selection. However, these arguments ignore the fact that banks basically specialize in optimizing credit portfolios not optimizing in credit and equity portfolios. Furthermore, since the Islamic banks' use of current accounts on the liability side is very high, the shocks on the assets side cannot be absorbed by these accounts on the liability side. Hence greater use of M-M on the asset side could actually cause a systemic instability given the large current accounts utilized by the Islamic banks.[24]

[24] See Tariqullah Khan and Ahmed Risk Management an analysis of issues in Islamic financial industry occasional paper 5,IRTI-IBD, Jeddah Saudi Arabia 1422H(2001)p.59.

3.8.3 Risk management Process in Ijara Financing

The risks faced in the Ijara financing are not altogether different from those in conventional leasing. However, there are differences in the way in which the financier may allocate the risks between itself and the borrower. Such risks can be mitigated by way of hedging and sharing the risks with third party risk takers such as insurers.

The following are the main features in the risk management of the new building financing involving Ijara depicted earlier:

1. The risk in Ijara principally revolves around the fact that the financial institution is the owner of the asset being financed. This ownership is helpful from the point of view that there is comfort for the financier who holds the asset, but it also carries the risk of liability to the financier should the deal turn sour.
2. The financier will have to assume the risks accompanying the ownership of the asset for the duration of the financing. Such risks include the risk of loss of the asset and the risk of claims by the borrower and by third parties
3. The lessor may seek to mitigate its risk by insuring the asset in its own name. The cost of doing this will be recoverable from the rental income accruing to it. In this manner, the responsibility for the management of the risks related to the asset may remain with the lessor.
4. In financing new buildings using Ijara, a sale and leaseback mechanism may be incorporated whereby the lessee will have been the previous owner of the asset. In such a case, the lease provides for 'quiet enjoyment' of the asset against the lessor.

A basic structural risk arising from Ijara financing is the requirement that the lessor may not contract to sell or lease the asset or to buy it once the financier has acquired it for that purpose. This risk is often mitigated by the party acquiring the asset acting as agent for the financier and promising to take it on lease, or to acquire it thereafter under an agreement entered into in a form agreed at the time the transaction is concluded.

If the asset is rendered unfit for sale or to be leased while being owned by the financier, for reasons not attributable to the customer, the risk will be borne by the financier. Under the Ijara structure shown above, the financier will be at risk for the duration of the financing. To mitigate this risk, the financier will seek to protect the value of the asset by obtaining the customer's agreement to maintain and operate the asset within certain agreed parameters. The financier will also retain the right to inspect the asset periodically to ensure compliance with the parameters agreed. Should the asset be rendered unsuitable for the purpose for which it is built, then the customer shall be released from its obligation to pay rentals. Therein lies crucial difference between an Ijara contract with conventional leasing where in the latter's case, the customer is required to continue to pay rentals irrespective of any inability to use the asset. This is – quite bluntly! - known in financing circles as the "hell or high water clause". But as is the case with conventional leasing, the Ijara contract will state that the financier can seek to manage the risk of loss or damage to its asset by means of insurance. As the financier's 'agent', the asset owner should not agree to take delivery of the asset if it is not satisfied with the asset's ability to comply with the specifications that the asset owner has agreed to, in relation to the purchase or lease of the asset.[25]

Ijara rental, like murabaha instalment becomes a debt on the customer after it becomes due. Therefore, it is subject to all the rules prescribed for defaults and delinquencies in repayment of debt. We have discussed the problem in the context of murabaha before. The solution is similar too.

The bank or financial institution is not allowed to charge the customer an additional amount in case of delays in payment of the rental since it is considered Riba. As a result, Islamic scholars have found a solution in order to prevent consequences resulting from the misuse of this prohibition. They suggested that the customer could be asked to pay a certain amount to charity.

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[25] See Marine Money Asia Edition To Lease or not to Lease: Ijara as a viable ship financing structure,Volume 3, Issue 14 July 03, 2008 P.6

The charity amount may vary according to the period of default, and may be calculated at percent per annum basis.

3.8.4. Risk management in the Contract of Salam

Since "selling what one does not have" is generally unacceptable on grounds of gharar, the structure of slam does not permit the bank to sell X before taking delivery of the same. Thus, the bank would need to wait till time of actual delivery before it can get back its investment and profits. This at times may not be very desirable, given the financial position of the bank. Another problem with the simplified structure is the price risk that the bank is now exposed to. It is quite possible that price of the commodity declines during time period t to a level below resulting in losses to the bank.

This risk is mitigated in a parallel or back-to-back salam, as the bank need not to participate in the market at all. In the case of parallel salam, once salam contract is concluded, the bank can enter the market as a seller of goods of similar specifications as it has previously purchased on first salam without making one contract depends on the other. Terms can be designed to fall at the same date of delivery. Since the period of salam in the second parallel transaction is shorter than the first transaction, the price may be a little higher, and the difference between the two prices becomes the profit earned by the bank or financial institution.

It is important to note here that bank is not actually selling those same goods, which were the subject of the first salam, but only the same. Hence there are two separate contracts, one the bank as a buyer and the other as a seller.

The price risk for the bank can also be mitigated in another way. If a third party makes a unilateral promise to buy the commodity at a predetermined price at time period t, then the bank

need not participate in the market. Thus, it would be insulated from price risk. This unilateral promise is binding. Once the rights resulting from the promise are transferred to the bank, it assumes the role of seller to the third party customer at time period t. Since it is only a promise, and not the actual sale, the clients will not have to pay the price in advance. Therefore, a higher price may be fixed and as soon as the bank or financial institution receives the commodity, it will be sold to the third party according to the terms of the promise.[26]

3.8.5 Risk management in the contract of Istisna

Istisna' involves the manufacturing of goods or the construction of buildings or other assets (ships, aircraft, etc.). Consequently, all risks associated with manufacturing or construction contracts are present in the contract of Istisna'. The major risks that have to be addressed in an Istisna' transaction, with regard to the relationship with the manufacturer, is the latter's failure to deliver the commodity in time, or his failure to deliver conforming goods. The failure to deliver the goods on time could be due to delay in the execution of the works, accident, or unforeseen events, the occurrence of a calamity (i.e. the goods are destroyed by fire or otherwise lost), or the insolvency of the manufacturer. The counterparty risks can range from failure to supply on time or even at all, and failure to supply the same quality of good as contractually agreed. Since Salam is an agricultural based contract, the counterparty risks may be due to factors beyond the normal credit quality of the client. For example, the credit quality of the client may be very good but the supply may not come as contractually agreed due to natural calamities. Since agriculture is exposed to catastrophic risks, the counterparty risks are expected to be more than normal in Salam.[27]

Istisna' involves various construction-related risks and risk of nonconformity to specifications (a performance risk). Since the client has no contractual relationship with the actual manufacturer

[26] See Mohamed el-Fatih Hamid, "Istisna' - Classical Concept in a Modern Framework", New Horizon Islamic Banking and Insurance, published by the Institute of Islamic Banking and Insurance, London No. 6, 1997, p.8.

[27] See Muhammed Al-Bashir Muhammed Al-Amine, Istisna' and Its Application in Islamic Banking Arab Law Quarterly, [2001] pp 22-48.

or contractor, the bank will always be liable for any failure. In order to mitigate such risks the agreement may contain a penalty clause.

1. Taking performance bond from the manufacturer or contractor or LG from contractors and warranties after delivery can reduce this risk.

2. Another alternative for the bank is to nominate the client as an agent to oversee satisfactory completion of the job.

3. If considered necessary, the bank may hire the services of an independent surveyor to monitor the progress of the project.

Like other financing mechanisms, Istisna' involves risk of default and delinquencies and a bank can take various measures such as mortgage on land on which the asset is being built, any other property or personal or third party guarantee to mitigate such risk.

In all cases the two contracts (bank vs. client, and bank vs. contractor or manufacturer) should always be separate.[28]

These issues can be addressed and the risk can be eliminated under the following principles:

3.8.5.1 **"Liquidated damages and the theory of unforeseen events".**

Al-Majma' al-Fiqhi al-Islami in its Resolution No. 66/3/7, 1992 concerning the contract of Istisna' includes a clause about liquidated damages and penalties.[29] By liquidated damages and penalties is mean a prior agreement between the parties to a contract about what sum shall be payable in the event of one party failing to complete or delaying his contractual obligation.

The basic source of legality of this concept lies in what is reported by al-Bukhari, narrated by Ibn Sirin that: "a man said to a hirer of animals, prepare your traveling animals and if I do not go

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[28] Jeremy Martin, "Security in Islamic Bank",New Horizon, London, No. 48, February 1996, p. 7

[29] See Muhammed Al-Bashir Muhammed Al-Amine, Sources*; Istisna' and Its Application in Islamic Banking* Arab Law Quarterly, [2001] pp 22-48

with you on such and such day, I shall pay you a hundred dirhams, but he did not go on that day. Shuraih said: "If anyone imposes a condition on himself of his own free will without being under duress he has to abide by it". Also it is narrated by Ayyub from Ibn Sirin that "A man sold food, and the buyer told the seller that if he did not come to him on Wednesday, then his deal would be cancelled, and he did not turn up on that day". Shuraih said to the buyer "You have broken your promise" and gave the verdict against him.[30]

Also we have the Hadith of the Prophet (pbuh) "Muslims are bound by their stipulations".[31] It is clear that the clause of liquidated damages is in the interest of the contract and it is a catalyst and an inducement for its fulfillment. Despite these evidence from the Sunnah, the topic did not receive ample attention from the classical jurists, but during the latter part of the Ottoman Empire, as pointed out by al-Zarqa, the topic has been revived.[32]

One of the recent extensive and detailed studies on the legality of the liquidated damages and punitive clause is the study of Hay'at Kibar al-'Ulama' in Saudi Arabia which analysed it through the general theory of contract and conditions. The council concluded unanimously that the punitive condition on a contract is a legal condition and must be taken into consideration unless there is an excuse for the non-fulfillment of this obligation. However, it should not be used as a means of financial threat, which in consequence will become incompatible with Shari'ah principles.[33]

However, the clause of liquidated damages is somewhat restricted by the effect of change of circumstances. In most legal systems, change in circumstances generates legal consequences that are, in turn, governed by a number of defined legal principles and rules. The doctrine of change

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[30] Al-Bukhari, Sahib al-Bukhari with Fath al-Bari (Book of Conditions) (Shurut), Vol. 5, p. 354..

[31] See Sunan al-Tirmidhi with Shark Tuhfat al-Ahwazi, Kitab al-Ahkam, Vol. 4, p. 584; Sunan Abi Dawud with 'Awn al-M'abut, Vol. 9, p. 516.

[32] Al-Zarqa, al-Madkhal al-Fiqhi al-'Am, cairo, Dar al-Fikr, Vol. 3, p. 386.

[33] Abhath *Hay'at Kibar al-'Ulama'*, Beurit, vol. 1, pp. 101-264.

in circumstances means: "Occurrences which radically disturb the equilibrium of a contractual obligation, making the performance excessively onerous for one of the contracting parties".[34]

It is possible to find authority for this doctrine in the following Qur'anic verses: "God commands justice and fair dealing (al-Nahl 16:90), "O ye who believe! Eat not up your property among yourselves in vanities" (al-Nissa' 4:29). It is possible also to prove the authority of this doctrine by the following legal maxims: "No harm may either be inflicted or reciprocated". "Necessity is judged according to its merits" (Majalla Art. 22); "Harm must be eliminated to an end" (Majalla Art. 20).

The relevance of this doctrine in the contract of Istisna' is like the case in any other obligation; the performance of the obligation of the parties to a valid contract can be frustrated by events beyond their control. These events make the performance of the contract either impossible or fundamentally different from that which was initially contemplated by the parties. Sometimes the impact of such events is so considerable that the performance of the contract is completely frustrated and the parties are therefore discharged from their obligations. However, it may be that the contract only needs readjustment to enable reasonable performance of the parties' obligation. The readjustment may be contractual, if the parties agree, or judicial, if the parties disagree. However, there is no agreed minimum level above which the buyer may be entitled to a reduction in the price. However, it seems that largely custom and changes of time and place influence this question. It is worth mentioning that al-Majma' al-Fiqhi al-Islami has a very important resolution. It decided that in deferred contractual obligations (such as the contracts of import and construction) if the situation has changed drastically and the fulfillment of the contractual obligations becomes very hard for one party as a result of price fluctuation for instance and not as a result of negligence or shortcoming from the affected party, the court can

[34] See Adnan Amkhan, "*The Effect of Change of Circumstances in Arab Contract Law*" [1994] ALQ 258.

intervene, if it has been notified, to balance the rights and obligations, by dividing the loss between the parties.

It is also possible to cancel the contract regarding the non-fulfilled part of the contract if it seems to the court to be the favorable solution with just and reasonable indemnities for the affected, party.. The court should rely on the opinion of reliable and trusted experts in its assessment. The court could also defer the fulfillment of the obligations if it becomes obvious that the unforeseen event will end soon and the second party will not be harmed by this deferment.[35]

However, for the application of this doctrine several conditions must be fulfilled. Thus, the event should be exceptional, unforeseeable, of a general character, and must occur during the time of performance of the contractual obligation excessively onerous for the contracting party invoking the doctrine of change of circumstances. There should also be a direct causative link between the exceptional, unforeseeable, and general event and the onerous nature of the performance.[36] But if the above-mentioned requirements have been shown to exist, the court has the power of intervention to adjust the onerous obligation. Before intervening in this way, the court may ask the contracting parties to re-negotiate the contract among them. Failing any agreement between the parties, the court's intervention will usually be affected either by reducing the aggrieved party's onerous obligation or by increasing the counter obligation.[37]

3.8.5.2. Insolvency of the manufacturer

Though liquidation, chronologically speaking, will be the last misfortune that can befall a company, it is being addressed here as the first risk in the context of Istisna'. This is to remind ourselves of the need to take the utmost care in the s election of the manufacturer and the

[35] See Qararat Majlis al-Majma' al-Fiqhi al-Islami li-Rabitat al-'Alam al-Islami, January 1985, pp. 99-104.
[36] See Adnan Amkhan, "*The Effect of Change of Circumstances in Arab Contract Law*" [1994] ALQ 258 at 263-268
[37] Ibid., 269.

rigorous examination of its financial standing and technical and administrative capability.[38]
There are some alternative measures for Islamic banks to protect their investment, such as:

- Taking a mortgage,
- Taking a charge over all the assets of the manufacturer,
- Taking a refunding bond guarantee,
- Taking a personal guarantee,
- Taking a bank guarantee from another bank, or
- Taking cheques for the instalment equal in value to the remainder of the sale price

after deducting any advance payment, which is paid at the time of signing the contract to purchase.[39]

3.8.5.3 Insurance and the contract of Istisna'

It is usual to deal with the risk over the loss of assets or their destruction (totally or partially) during construction or manufacturing by means of insurance. The manufacturer should, therefore, be obliged to take out the appropriate insurance policies and assign the proceeds of these policies to the Islamic bank concerned.

In case of partial loss, the manufacturer may be allowed to use the proceeds of insurance to restore the asset to its condition before the occurrence of loss. If, as a result of events beyond the control of the parties, such as floods, earthquakes, volcanic eruptions, and other natural disasters, or adverse political actions, such as expropriation, change of law, war, etc. the manufacturer is unable to complete the construction or the manufacturing, a reasonable extension of time may be granted.

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[38] See Mohamed el-Fatih Hamid, *"Istisna' - Classical Concept in a Modern Framework"*, New Horizon Islamic Banking and Insurance, published by the Institute of Islamic Banking and Insurance, London No. 6, 1997, p.6.

[39] See Jeremy Martin, *"Security in Islamic Bank"*, New Horizon, London, No. 48, February 1996, p. 5.

If, after this extension of time, the manufacturer could not complete the manufacturing of the assets, the contract may be terminated and the buyer can claim a refund of the payments, which he has paid and compensation for any loss caused by such a delay.[40]

Thus, the contract with the manufacturer shall require him to insure the assets under manufacture and until their delivery for their full replacement value under a contractor's all risk policy.[41]

3.9 Appropriate contractual agreements between counterparties work as risk control techniques.

Gharar (uncertainty of outcome caused by ambiguous conditions in contracts of deferred exchange) could be mild and unavoidable but could also be excessive and cause injustices, contract failures and defaults. Appropriate contractual agreements between counterparties work as risk control techniques. A number of these can be cited as an example.

a) Price fluctuations after signing a Salam contract may work as a disincentive for fulfilling contractual obligations. Hence if the price of, for example, wheat appreciates substantially after signing the contract and receiving the price in advance, the wheat grower will have an incentive to default on the contract. The risk can be minimized by a clause in the contract showing an agreement between the two parties that a certain level of price fluctuation will be acceptable, but beyond that point the gaining party shall compensate the party, which is adversely effected by the price movements. In Sudan, such a contractual arrangement known as Band al-I□sān (beneficence clause) has now become a regular feature of the Salam contract.

b) In Istisnā‘, contract enforceability becomes a problem particularly with respect to fulfilling the qualitative specifications. To overcome such counterparty risks, Fiqh scholars have allowed Band al-Jazāa (penalty clause).

[40]See Mohammed el-Fatih Hamid, *"Istisna' Classical Concept"*, p. 7.
[41] Islamic Development Bank, "Operational Guidelines", p. 8

c) Again in Istisnā' financing, disbursement of funds can be agreed on a staggered basis subject to different phases of the construction instead of lumping them towards the beginning of the construction work. This could reduce the banks' credit exposure considerably by aligning payments with the progress of the work.

d) In Murābaha, to overcome the counterparty risks arising from the nonbonding nature of the contract, up-front payment of a substantial commitment fee has become permanent feature of the contract.

e) In several contracts, as an incentive for enhancing re-payment, a rebate on the remaining amount of mark-up is given.

f) Due to non-presence of a formal litigation system, dispute settlement is one of the serious risk factors in Islamic banking. To overcome such risks, the counterparties can contractually agree on a process to be followed if disputes become inevitable. This is particularly significant with respect to settlement of defaults, as interest-based debt rescheduling is not possible.

g) It can be proposed that to avoid the default by the client in taking possession of the ordered goods, the contract shall be binding on the client and not binding on the bank. This suggestion assumes that the bank will honor the contract and supply the goods as contractually agreed, even if the contract is not binding on it. An alternative proposal could be to establish a Murābaha clearing market (MCM) to settle cases, which may not be cleared due to the non-binding nature of the Murābaha contract.

h) Since the Murābaha contract is approved with the condition that the bank will take possession of the asset, at least theoretically the bank holds the asset for some time. This holding period is almost eliminated by the Islamic banks by appointing the client as an agent for the bank to buy the asset. Nevertheless, the raison d'être of approving the contract is the responsibility of the bank for the ownership risk. For this risk therefore, capital needs to be allocated.

All these features of contracts serve to mitigate counter party default risks. Similar features can enhance the credit quality of contracts in different circumstances. It is desirable to make a maximum benefit of such features wherever new contracts are being written.[42]

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[42] See Tariqullah Khan and Ahmad Risk Management an analysis of issues in Islamic financial industry, ccasional paper 5,IRTI-IDB,Saudi Arabia 1422H(2001)p,126.

CHAPTER-IV

4. REGULATION AND SUPERVISION OF ISLAMIC BANKS

There should be no disagreement on the statement that the risk management systems in the Islamic banks should meet the required international standards. However, as mentioned above a number of risks faced by the Islamic banks are different as compared to the risks of traditional banks. Therefore, some international standards meant for traditional banks may not be relevant for the Islamic banks due to their different nature. Hence the effective supervision of Islamic banks requires the study of the risks of Islamic banks and formulating suitable guidelines for the effective supervisory oversight of Islamic banks. Chapra and Khan (2000) undertake a survey of regulation and supervision of Islamic banks. Some pertinent conclusions of that study are presented here.[1]

4.1 Relevance of the International Standards for Islamic Banks[2]

i. The Core Principles document sets pre-conditions for effective banking supervision. In addition to these pre-conditions, there are also a number of other pre-conditions specific for the effective Islamic banking supervision. One set of these preconditions has to be fulfilled by the regulators and supervisors. These include providing a leveled playing field for competition, licensing facilities, lender of last resort facility acceptable to the mandate of Islamic banks, proper legal framework, proper *Shari 'ah* supervision, etc. The other set of preconditions has to be met by the Islamic banks themselves. These include development of [illegible] money market and instruments, resolution of a number of unresolved *Fiqh* related issues,

[1] See Chapra, M. Umer and Khan, Tariqullah (2000), Regulation and Supervision of Islamic Banks, Jeddah: IRTI-IDB, Occasional Paper No.3.

[2] For international standards, see, Financial Stability Forum, International Standards and Codes to Strengthen Financial System ([illegible].org/standards/keystds.htm). In addition, the Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) needs to be mentioned specially as it is the sole standard setter for the Islamic financial [illegible]

[illegible] of proper internal control and risk management systems, etc.

ii. [illegible] Core Principles for effective banking supervision and the disclosure and [illegible] requirements are concerned, these are equally relevant for the Islamic banks. [illegible] sharing nature of Islamic banks, these banks need even more effective systems [illegible] supervision and transparency.

iii. [illegible] in applying the international standards to Islamic banks lies in applying capital [illegible] standards. First, due to the risk sharing nature of their modes of finance, Islamic [illegible] more not lesser capital as compared to traditional banks. Second, there is a need [illegible] the capital of current and investment accounts. Third, the need to adapt the [illegible] standards for the Islamic banks has prompted efforts towards establishing the [illegible] of the Islamic Financial Services Supervisory Board. Finally, the supervisory [illegible] systems like CAMELS[3] are equally relevant for Islamic banks and these can [illegible] without difficulty.

iv. [illegible] advantages of the IRB approach[4] are relevant for the Islamic banks. First, the [illegible] mapping the risk profile of each asset individually. Since the Islamic modes [illegible] diverse, the IRB approach suits these modes more than the standardized [illegible] the IRB approach aligns the actual risk exposure of banks with their [illegible] requirements. This is consistent with the nature of Islamic banks. Third, the IRB [illegible] expected to encourage and motivate banks to develop a risk management culture [illegible] reduce the risks in the banking industry and enhance stability and efficiency. [illegible] expected to generate reliable data and information and enhance transparency and

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[3] The C[illegible] system refers to capital adequacy, assets quality, management quality, earnings, liquidity, and sen[illegible] risks (in some countries also systems for internal controls).

[4] IRB [illegible] bank in accordance with the risk characteristics of each asset. All banks have some systems of inte[illegible] for provisioning loan loss reserves, but an increasing number of banks are putting in place form[illegible] often based on computerized models. Internal Rating Board (IRB) approach lesser than the stan[illegible] It also aims at enhancing disclosures about risk management systems and other important infor[illegible] market discipline can be strengthened.

market discipline. Fifth, it will use external credit assessment as benchmark, and thus truly [illegible] internal and external information to generate more reliable data. This is important [illegible] internal credit assessment may not have the full set of reliable information that an external-ratings system can have, and internal-rating systems may lack the objectivity of external ratings. This information, used in harmony with incentives for risk management, [illegible] instrumental in controlling moral hazard and capital arbitrage.

4.2 The Present State of Islamic Banking Supervision

Most [illegible] are located in the member countries of the IDB. The study mentioned above identi[illegible] of issues regarding the present state of Islamic banking supervision. A growing numb[illegible] countries are in the process of adopting and effectively implementing the intern[illegible]s, namely, Core Principles, minimum risk-weighted capital requirements and the in[illegible] accounting standards. In applying the risk-weighting methodologies to Islamic banks, [illegible] difficulties reported due to the diverse nature of the Islamic modes of finance. Comp[illegible] with the standards set by the Accounting & Auditing Organization for Islamic Finan[illegible] (AAOIFI) has not yet fully materialized.

i. S[illegible] including Iran, Pakistan and Sudan are undertaking financial sector reform pr[illegible] strengthening the capital of banks [illegible] an important part of these programs. Since most Is[illegible] very small, some countries have announced a program of mandatory merger of Is[illegible] strengthen their capital base.

ii. A [illegible] number of countries where there are Islamic banks located, are putting in place [illegible] On-site supervisory system. The famous On-site supervisory risk assessment s[illegible] CAMELS is also being used in some countries. Islamic banks are generally [illegible] within the framework of the prevailing international commercial banking

su[illegible] systems. In some countries special laws have been introduced to facilitate Islamic b[illegible] in others no such laws exist. Islamic banking operations in the latter group of co[illegible] are performed under the guidelines issued by their respective central banks.

iii. In [illegible] all these countries where Islamic banks are operating, commercial banking functions ar[illegible] from securities and insurance businesses, and distinct authorities are assigned the s[illegible]. Malaysia is the only exception, where banks and insurance companies are s[illegible] by the central bank. However, the global trend is inclined towards the concept of u[illegible] banking with emphasis on supervision by a single mega-supervisor. Moreover, c[illegible] in these countries are supervised by central banks. However, the emerging tr[illegible] the world is to segregate the monetary policy framework of macroeconomic m[illegible] the microeconomic considerations of bank soundness. As a result of this s[illegible] supervision is being separated from monetary policy and being assigned to a[illegible] authority. In cases where different supervisory authorities specialize in supervising d[illegible] and non-banking financial institutions, the need for cooperation and c[illegible] between these authorities increases.

v. [illegible] tries conventional banks are allowed to open Islamic windows, while in other [illegible] es this is not allowed.

vi. [illegible] banks have their own *Shari 'ah* supervisory boards. However, in Malaysia, [illegible] Sudan the central banks have a central *Shari 'ah* board. In Pakistan the Council [illegible] logy and the Federal *Shari* Court are empowered to review all laws in the [illegible] *ri 'ah.* The Federal *Shariat* Court has declared interest to be a form of ***Riba***.

vii. [illegible] characteristics of Islamic banks require that the existing international standards [illegible] erly adapted to apply these to Islamic banking supervision effectively. The risk [illegible] of investment deposits, the risks of various Islamic products, the availability of

[illegible] ment instruments, the presence of institutional support such as lender of last resort [illegible] and [illegible] posit protection are some of [illegible] most important among these factors.

The [illegible] in concern has been to develop accounting, auditing and income recognition stan[illegible] Islamic financial institutions so that transparency and disclosures can be enh[illegible] institutions, which [illegible] an Islamic requirement for conducting fair and honest busi[illegible] the [illegible] process of developing the sta[illegible]ds, AAOIFI found that most Islamic banks are repo[illegible] investment deposits as off-balan[illegible] sheet items. After a thorough technical analysis, AA[illegible] reached [illegible]vo crucial conclusions.

i. [illegible] ed to differentiate two types [illegible] f investment deposits; those restricted to a specific [illegible] nd general-purpose unrestricted dep[illegible]its. The magnitude of the first type of deposits is [illegible] compared to the second typ[illegible] of deposits. While the Islamic banks can continue [illegible] rst type of deposits off-bal[illegible] sheet, the second type of deposits shall be kept [illegible] lance [illegible]heet.

ii. [illegible] ank [illegible] managing investment de[illegible]its must face fiduciary and displaced commercial [illegible] Fid[illegible] ry risk can be caused by b[illegible]h of contract by the Islamic bank. For example, [illegible] not be able to fully com[illegible]y with the *Shari 'ah* requirements of various [illegible]cts. While, the justification for Isla[illegible]c banking is the compliance with the ***Shari 'ah,*** [illegible] to do so or not doing so wil[illegible]fully can cause a serious confidence problem and [illegible] drawal. Displaced c[illegible]mmerc[illegible] risk implies that the bank though may operate in [illegible] with the *Shari 'ah* re[illegible]ments, yet may not be able to pay competitive [illegible] as compared to its peer gr[illegible] Islamic banks and other competitors. Depositors [illegible] ve the incentive to seek wi[illegible]awal. To prevent withdrawal, the owners of the [illegible] will [illegible] ed to apportion part of the[illegible] own share in profits to the investment depositors. AA[illegible] thus sug[illegible]ests that [illegible]he Isl[illegible] bank's capital shall bear the risks of all assets

[illegible] current accounts and capital. In addition, the capital shall also bear the risks of [illegible] of assets financed by the investment deposits. The risks of the remaining half of the [illegible] financed by the investment deposits shall be borne by the investment depositors.

The risk of withdrawal is in fact a nightmare for the managers of Islamic banks. This risk is ndeed more [illegible] in Islamic banks as compared to conventional banks. This is because, neither the principal [illegible] return is guaranteed in Islamic banks' investment deposits unlike the deposits of conventional banks. Although the nature of Islamic banks' investment deposits does introduce market discipline, it also causes a potential confidence problem as compared to traditional bank deposits. Therefore, Chapra and Khan (2000) show reservations about the AAOIFI suggestion to make [illegible] responsible for the risks of only 50% of assets financed by investment deposits, as this [illegible] weaken the capital of Islamic banks. They argue that due to the confidence problem mentioned above Islamic banks in fact should need more capital as compared to conventional banks. [illegible] capital base coupled with the market discipline introduced by the nature of investment deposits can indeed make Islamic banks more stable and efficient.

[illegible] concern of AAOIFI namely, the prevention of the transmission of risks of investment deposits to current accounts is of a fundamental nature. To strengthen this concern, Chapra and Khan (2000) suggest for the consideration of standard setters that the capital requirement for demand deposits must be completely separated from the capital requirement for investment deposits. Islamic banks can thus have two alternatives with respect to capital adequacy requirements. The first alternative would be to keep demand deposits in the banking book and investment deposits in the trading book with separate capital adequacy requirements for the two books. The second alternative would be to pool investment deposits into a securities subsidiary of the bank with separate capital adequacy requirement. There could be other subsidiaries, of an Islamic bank [illegible] with separate capital requirements.

4.3 SUGGESTIONS AND RECOMMENDATIONS

Based on what has been reported in this study, a number of policy implications can be suggested for the development of risk management culture in the Islamic financial institutions. Some of these are mentioned here.

4.3.1 Management Responsibility

A risk management culture in Islamic banks can be introduced by involving all the departments/sections in the risk management process discussed. In particular, the Board of Directors can create a risk management environment by clearly identifying the risk objectives and strategies. The management role is to implement these policies efficiently by establishing systems that can identify, measure, monitor, and manage various risk exposures. To ensure the effectiveness of the risk management process, Islamic banks also need to establish a proficient internal control system.

4.3.2 Risk Reports

Risk reporting is extremely important for the development of an efficient risk management system. We consider that the risk management systems in Islamic banks can be substantially improved by allocating resources to preparing the following periodic risk reports.

Capital Risk Report

Credit Risk Report

Aggregate Market Risk Report Interest Rate Risk Report

Liquidity Risk Report

Foreign Exchange Risk Report

vii. Commodities and Equities Position Risk Report

viii. [illegible] Risk Report

ix. [illegible] Risk Report

4.3.3 Internal Ratings

At initial stages of its introduction an internal rating system may be seen as a risk-based inventory of individual assets of a bank. Such systems have proved highly effective in filling the gaps in risk management systems, hence enhancing the external rating of the concerned institutions. This contributes to cutting the cost of funds. Internal rating systems are also very relevant for the Islamic modes of finance. Most Islamic banks already use some form of internal ratings. However, these systems need to be strengthened in all Islamic banks.

4.3.4 Risk Disclosures

Disclosures of risk management systems are extremely important for strengthening the systems. Introduction of standard risk-based systems as given here can enhance risk disclosures.

i. Risk-based Management Information System
ii. Risk-based Internal Audit Systems
iii. Risk-based Accounting Systems and
iv. Risk-based Asset Inventory System

4.3.5 Supporting Institutions and Facilities

The risks facing the Islamic financial industry can be reduced to a great extent by establishing a number of Shari'ah compatible supporting institutions and facilities such as:

Lender of last resort facility,

Deposit protection system,

Liquidity management system,

Legal reforms to facilitate Islamic banking and dispute settlement etc.,

Uniform Shari'ah standards,

Adoption of AAOIFI standards, and

Establishing a supervisory board for the industry.

4.3.6 Participation in the Process of Developing the International Standards

The Islamic financial industry being a part of the global financial markets is effected by the international standards. In fact compliance with these standards wherever relevant and feasible is expected to enhance the endorsement of the Islamic financial institutions by the international standard setters. This in turn is expected to enhance the growth and stability of the industry. It is thus imperative for the Islamic financial institutions to follow-up the process of standard setting and to respond to the consultative documents distributed in this regard by the standard setters on a regular basis.

4.3.7 Research and Training

Risk management systems strengthen financial institutions. Therefore, risk management needs to be assigned as a priority area of research and training programs. Given the nascent nature of the Islamic financial industry there is a need to develop *Shari 'ah* compatible risk management techniques and organize training programs to disseminate these among the Islamic banks. In the present research we have made an attempt to cover a number of issues. These and other issues can constitute an agenda for future research and training in the area. The training programs need to be designed for ***Shari 'ah*** supervisors, regulators and managers of the Islamic financial institutions.

Islamic banking industry has been trying for the last over two decades to extend its outreach to bring it at least to the level of conventional banking. But the **absence of Shariah-compliant legal**

framew[illegible] needed to make interest-free banking acceptable (and create sound financial institutions [illegible] major snag behind its low penetration in the financial market. It is the time to take st[illegible] challenges faced by the Islamic banks as they need a number of supporting institution[illegible] to perform functions which are being carried out by various financial institution[illegible] the conventional framework. Attempts should be made to modify the existing structu[illegible] better products and quality service within the

ambit [illegible]

4.3.8 Legal Support

Islamic [illegible] own framework for execution of commercial and financial contracts and transactions. [illegible] commercial banking and company laws appropriate for implementation of Islamic [illegible] and financial contracts do not exist. Islamic banking contracts are treated as buying [illegible] properties and hence are taxed twice.

The co[illegible] banking and company laws contain provisions that are narrowly defined and prohibit [illegible] Islamic banking activities within conventional limits. It is necessary that special [illegible] introduction and practice of Islamic banking be put in place. **The legal framew**[illegible] **banking and finances might include the following:**

a. [illegible] **courts**: The disputed cases of the Islamic banks are subject to the same legal system [illegible] dealt with the same court and judge as the conventional one while the nature of the legal [illegible] is totally different. To ensure a proper, speedy and supporting Islamic legal system, [illegible] in existing laws, which are repugnant to injunctions of Islam, are required to promulgate [illegible] law for resolution of disputes through special courts.

b. Amendment of existing laws: Islamic banking has some kind of resemblance to universal banking, therefore laws and regulations have to be amended accordingly to accommodate this new concept such as sections 7 (forms of business in which the banking company can engage) and 9 (prohibition of trade) of the Banking Companies Ordinance 1962 while Islamic banks are big or wholes[illegible] [illegible]ty.

c. Islamic banking laws: In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and 2 companies' laws in several countries require suitable modifications to provide a levelplaying field for Islamic banks. Furthermore, the international acceptance of Islamic financial contracts requires them to be Shariah compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

d. Islamic banking balance sheet: Islamic banks do not show assets financed through Ijara, Murabaha etc. in balance sheet because section 7 of Banking Ordinance 1962 does not allow a bank to own pr[illegible] which section 9 prohibits to enter into any kind of trade. However, all the assets owned by Islamic banks be mentioned in their balance sheets.

e. Monthly payment agreement: The housing finance is executed on the basis of Diminishing Musharaka [illegible] Islamic banks. Under this mode the house is jointly owned by the bank and the customer. The bank rents out its share to the customer on Ijara basis. The Islamic bank while executing [illegible] with the partner/customer, uses the term 'Monthly Payment Agreement' instead of having [illegible] with the customer. It is so named as to safeguard the bank's interest in case of [illegible] customer to pay rentals. No legal cover is provided to the Islamic bank to overcome [illegible]

f. PLS deposits: Deposits in Islamic banks are usually based on principle of profit and loss (Musharaka or Mudaraba). If something happens and the bank suffers loss it has to be transferred to the depositors directly. This fear of loss is the biggest barrier to deposit mobilisation in Islamic banks. In some cases, it leads to withdrawal of funds. The depositors should be provided with some kind of protection

4.3.9 Islamic prudential regulations

Supervision of Islamic banks is equally important. At present, lack of effective prudential regulation is one of the weaknesses of the Islamic banking industry. For instance, leasing prudential regulations are applied to Ijara where the nature of both is different, such as taking advances. The bank is the owner in Ijara so taking advances will render the contract of Ijara for conversion into Musharakah whereas the rules of Ijara are applied to it, which is illegal. And some of the Islamic banks are using the term of security hence making the Ijara contract non-Shariah compliant as using the deposited sum under the heading of Ijara security ('Rahn') is nothing but Riba which is strictly prohibited by Islam. Moreover, Ijara financing is subject to compulsory insurance which is essentially prohibited.

4.3.10 Benchmark

Taking the conventional interest based benchmarks (Kibor etc.,) as the base of pricing an Islamic financial product leaves Islamic banks at the mercy of their 3 conventional peers. A negative perception is created among the clientele that there is no prudent difference in Islamic bank products as these are based on the same interest based benchmark. The mechanism for long-term financing could be devised on the basis of prevailing renting system adopted by the private landlords while renting their houses/properties etc.

4.3.11 Shariah based product

All Islamic financial institutions offer the same basic products, (90 per cent Murabaha and Ijarah) but the problem is that each institution has its own group of Islamic scholars on the Shariah board to approve the product. Consequently, the very same product may have different features and will be subject to different kind of rules in these institutions. Lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered.

4.3.12 Lender of last resort facility

Islamic banks are reluctant to enter into long term transactions due the lack of availability of liquidation through secondary market. There is liquidity support in the form of lender of last resort facility. There is no proper mechanism of transparency and disclosure to the public in order to ensure consumer protection as provided by Shariah.

4.3.13 Islamic future exchange

In conventional system, long term finance is provided through long-term bonds and equities. Apart from the general public, the most important source of these long-term investments are investment banks, mutual funds, insurance companies and pension funds. Islamic banks do not deal with interest bearing bonds. Therefore, their need for equity markets is much higher. On the top of it, the most of the products in Islamic banks are based on goods and commodities while prices and

currency rates go up and down frequently, creating a big risk for them being traders in reality especially in the case of Salam and Istisna'a. To hedge the risk, they are in need of derivative products and consequently of Future Exchanges.

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CONCLUSION

Islamic financial industry has come a long way during its short history. The future of these institutions, however, will depend on how they cope with the rapidly changing financial world. With globalization and informational technology revolution, scopes of different financial institutions have expanded beyond national jurisdictions. As a result, the financial sector in particular has become more dynamic, competitive, and complex. Moreover, there is a rapidly growing trend of cross-segment mergers, acquisitions and financial consolidation, which blurs the unique risks of the various segments of the financial industry. Furthermore, there has been an unprecedented development in computing, mathematical finance and innovation of risk management techniques. All these developments are expected to magnify the challenges that Islamic financial institutions face particularly as more well established conventional institutions have started to provide Islamic financial products. Islamic financial institutions need to equip themselves with the up-to-date management skills and operational systems to cope with this environment. One major factor that will determine the survival and growth of the industry is how well these institutions manage the risks generated in providing Islamic investment modes.

Studying risk management issues of the Islamic modes of finance is an important but complex subject. The present study discusses and analyzes a number of issues concerning the subject. First, it presents an overview of the concepts of risks and risk management techniques and standards from Islamic perspective, as these exist in the financial industry. Second, the unique risks of the Islamic modes of finance and the perceptions of Islamic banks about these risks Third, the main regulatory concerns with respect to risks and their treatment with a view to draw some lessons for Islamic banks are discussed. Fifth, a number of *Shari 'ah* related challenges concerning risk management are identified and discussed. Finally, some important suggestions and recommendations are given to achieve the desired goals:

The study concludes that Risk is associated with all Islamic financial contracts. Risk management processes and techniques enable financial institutions to control undesirable risks and to take benefit of the business opportunities created by the desirable ones. These processes are of important concern for regulators and supervisors as these determine the overall efficiency and stability of the financial systems.

The study shows that the Islamic financial institutions face two types of risks. The first type of risks they have in common with traditional banks as financial intermediaries, such as credit risk, market risk, liquidity risk and operational risk. However, due to *Shari 'ah* compliance the nature of these risks changes. The second type is of new and unique risks that the Islamic banks face as a result of their unique asset and liability structures. Consequently the processes and techniques of risk identification and management available to the Islamic banks could be of two types – standard techniques which are not in conflict with the Islamic principles of finance and techniques which are new or adapted keeping in view their special requirements.

Due to their unique nature, the Islamic institutions need to develop more rigorous risk identification and management systems. The paper identifies a number of policy implications the implementation of which can be instrumental in promoting a risk management culture in the Islamic financial industry.

i. The management of all banks need to create a risk management environment by clearly identifying the risk objectives and strategies of the institution and by establishing systems that can identify, measure, monitor, and manage various risk exposures. To ensure the effectiveness of the risk management process, Islamic banks also need to establish a proficient internal control system.

ii. Risk reporting is extremely important for the development of an efficient risk management system. The risk management systems in Islamic banks can be substantially improved by

allocating resources for preparing a number of periodic risk reports such as capital at risk reports, credit risk reports, operational risk reports, liquidity risk reports and market risk reports.

iv. Risk-based management information, internal and external audit, and asset inventory systems can greatly enhance risk management systems and processes.

v. Substantial risks faced by the Islamic banks can be reduced if a number of supporting institutions and facilities are provided. These include a lender of last resort facility, deposit protection system, liquidity management system, legal reforms to facilitate Islamic banking and dispute settlement, uniform *Shari 'ah* standards, adoption of AAOIFI standards and establishing a supervisory board for the industry.

vi. The Islamic financial industry being a part of the global financial markets is effected by the international standards. It is thus imperative for the Islamic financial institutions to follow-up the process of standard setting and to respond to the consultative documents distributed in this regard by the standard setters on a regular basis.

vii. Legal frame work for the Islamic Banks should be developed and the existing laws should be changed to make it in conformity with Shariah.

viii. Risk management systems strengthen financial institutions. Therefore, risk management needs to be assigned a priority in research and training programs.

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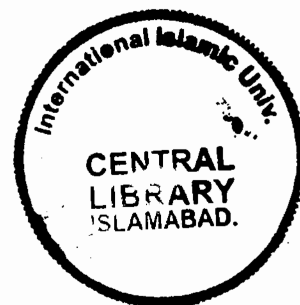
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