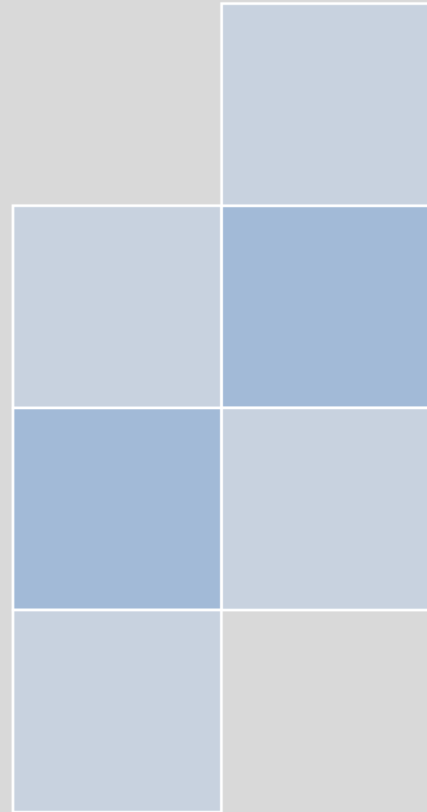
CREDIT RISKS
IN ISLAMIC BANK FINANCE



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Introduction

There is no doubt that the concept of risk was well known to ancient societies. Even in financial decisions, there is no doubt that people knew very well that lending to someone who is bankrupt has a high probability of losing your money as compared to a good standing debtor. Nevertheless, risk became an important tool of decision making when it becomes possible to measure risk and to assign values to different situations I select the best possible one. Therefore, I didn't claim in this paper that our forefathers didn't know the concept of risk. Nor that they didn't recognize credit riskness, albeit, they didn't have an effective measurement for risk. What I claim is that the concept of risk frequently mentioned by jurists in their studies of the theory of contract, has nothing to do with the concept of risk as known in financial studies. Such distinction is important. This is because as jurists refer to certain "risky" contract and render them unacceptable from Shari'ah point of view, some practioners of Islamic finance took as they refer to risk in the jargon of finance. Nothing can be forth from the truth.

Certainly we should benefit from the great advances in the studying of risk and risk management technique in finance. However, it also means that we have to develop our own theory of that deals with our unique concept or risk, one I tried to eliminate in this paper.

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1 The Importance of the Topic

Theoretical studies on Islamic banking have focused in the past on Islamic forms of financing and on their capacity to rise to the demands of financial intermediation for catering to the needs of the people by substituting interest based, and, at the same time loans ensuring the compatibility of these forms with laws regulating banking operations. Bank control, however, has not received its due share in these studies. It is common knowledge that bank control is concerned with aspects of risk in banking operations. As the bank is the trustee of public funds it is incumbent upon it to utilize these funds with the constant and utmost endeavor of being able to meet their claims on these funds. It is for this reason that comparative studies on risk underlying the Islamic forms (of financing) are extremely important. They promote a sound understanding, from the technical perspective, of various aspects of Islamic banking operations, an understanding that is needed by supervisory institutions. Likewise they counter an objection that is usually raised in banking circles to the effect that Islamic modes (of finance) bear a much higher risk than interest bearing loans. Considering the fact that this topic is in its infancy, what the researcher offers is a small effort, an introduction to the topic, and the throwing of light on aspects that will, perhaps, become the subject of future studies.

2 The Meaning of Credit

Al-I'timān is a term that is correctly used by economists to denote the meaning of the foreign term "credit”. This is a sound translation of the term in its precise meanings. In some dictionaries, the following meanings are given under the term credit:

> It is the confidence inspired in people that a certain person is wealthy.

The author of the dictionary adds thereafter:

> It is an obligation created by the bank for one who demands from it that he be permitted to use some particular wealth on account of the confidence reposed in him with respect to it.[1]

This gives the precise meaning of the term *i'timān*. The norm is that it is incorrect to assume that *i`timān* (credit) means (the granting of a) loan, be-cause loan is a consequence subservient to credit. Further, *i`timān* (credit) is the confidence reposed by the bank in one dealing with it before it is prepared to grant a loan or provide a guarantee. Accordingly, loan is de-pendent on this confidence and a result of it and it is not *i‘timān* (credit) itself. Guarantee is part of what is termed credit in terms of banking and is based on the same “confidence.”

[1] Khalīl Shaybūb, *Mu‘jam Qānūnī* (1949).

It has been defined by some banking dictionaries as “the ability to raise loans and purchase goods in return for a promise to pay in the future.” There are others who have defined it as “Man’s confidence in Man.”[2]

Please consult the original works and substitute the definitions. These works were not available here. Translator

3 The Meaning of Risk in Financial Literature

The concept of risk hardly needs a definition as its meaning is evident and is employed by people in their everyday conversation. If the speaker were to say “There is risk in a certain thing,” the person listening would under-stand that he is talking about a situation where there is uncertainty as to the occurrence of desired results and the probability that the consequence would be something that is not desirable. This is exactly what is meant by risk (*mukhātarah*) in the terminology employed in studies on finance. It points to a situation in which we face the probability of two occurrences each of which is possible. It is evident that circumstances in which we face the probability of a single occurrence are circumstances that bear no risk.

Mukhātarah (risk) is defined by one writer as “the situation that includes the probability of deviation from the path that leads to the expected or usual result.”[3] Another writer has stated that in simple terms it means “The likelihood of loss.”[4]

Risk is an ingredient that is never absent from an act undertaken by a human being, but it acquires special significance when the study is of risk as an ingredient of the process of arriving at financial decisions. The ability of assets to yield expected returns is something not guaranteed. We, therefore, strive consistently to study the forces that are likely to affect the ability of such assets to generate returns.

Risk is studied as a subject within several social sciences. Among these are the sciences of Statistics, Economics, Financial Management and Insurance. There is no doubt that the examination of risk in each of these sciences has specific attributes that differ from those in other disciplines. Despite the intricacies that surround the discussions of risk, its meaning in all these disciplines does not go beyond what has been stated above. The purpose of studying risk is not elimination because that is impossible. The purpose is to acquire some control over such risk and to manage it in a way that reduces its harmful effects on the consequences of the decision that we need to take.

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[2] Barrons, *Dictionary of Financial and Investment Terms.*

[3] *Vaughan, Fundamentals of Risk and Insurance*, p.7.

[4] Megginson, *Corporate Finance Theory*, p.95.

4 Measuring ***Mukhātarah*** (Risk)

The fact is that the meaning of risk has no significance from the practical perspective if it cannot be measured. As the meaning of *mukhātarah* (risk) is simple and is clear in the minds of people, they tend to differentiate between higher risk and lower risk. The likelihood of an undesirable occurrence has various grades. The risk of being affected by diseases of the lungs faced by a person who smokes three packets of cigarettes a day is greater than that faced by a person who does not smoke. Likewise, the existence of a single bullet in the revolver of a person playing Russian roulette means that he faces a risk of death that is less as compared to the person in whose revolver there are two bullets, and it is more than both of these for the person whose revolver has three bullets. Thus, insofar as the risk is less or more, there are levels between the two extremes. This is what leads to the need for criteria for measuring risk and for classifying it in a manner that enables its identification in a vivid form. The criteria are also employed for comparing the risk inherent in various decisions inter se and for comparing the expected return on investment.

There are various ways of classifying risk and for measuring it and this is undertaken by specialized institutions. The banks and insurance companies too have developed special measuring standards for risk. When investment opportunities bear a higher risk, it does not mean that people will not accept them. They will where it is possible to measure risk and such risk is accompanied by adequate returns, and they are of the view that these are suitable for the level of the (inherent) risk. The people will, however, not accept the investment opportunities that are surrounded by ambiguous and unclear risk measures that do not identify whether the inherent risk is more of less. This ambiguity is itself a form of risk. Thus, investment in which the measures of risk are not clear will be reckoned as being a high risk investment.

The roots of human efforts for (seeking) measures of risk are old and go back to the seventeenth century when Pascal the famous mathematician, uncovered the theory of probability while attempting to find a solution to the riddle rolling of the dice and then the law of large numbers that enabled the utilization of abundant information of the past to predict what will happen tomorrow, natural distribution in Statistics, and coefficients. All this led up to Harry Markowitz who established in 1959 that human beings could reduce risk in the money markets by means of diversification of investments.[5] Markowitz began his study with the assumption that the selection of an investment portfolio should rely on an average return on investment and on a measure of variation for such return.

Average return is an expression used for the weighted average for all types of assets included in the portfolio. The risk in the portfolio with reference to the portfolio will be less whenever the link between the assets that are included in the portfolio is the

[5] Harry Markowitz, *Portfolio Selection: Efficient Diversification of Investments* (n.p.: John Wiley, 1959).

minimum of what it can possibly be. This was an idea that he called the rule of diversification. Based on this, it is possible to say that the risk involved in owning any asset in an investment portfolio has two components. The first can be made to decrease to the extent of disappearance during the process of diversification that has been indicated above, while the second element of risk must be borne by the investor. Accordingly, the theory of investment portfolio selection is in reality an option between granting importance to return while reducing the risk involved. From a different perspective, the factors linking the investment instruments (forms of investment) become and effective element in portfolio selection whose importance is not less than the investment assets within it, and it is not possible to evaluate these instruments in isolation from each other. Each instrument acquires its importance in proportion to the extent of its participation in the total return on the portfolio.

It is for this reason that the applications of Markowitz's theory require a thorough understanding of averages, measures of variation and coefficients for all the assets that can possibly constitute the portfolio. The next movement came at the hands of Sharpe[6] when he established that the investor acquires a return in proportion to the element of risk that cannot be eliminated by means of diversification. If a human being expects a return on risk that he cannot bear or to get rid of as far as possible, he fails, by necessity, in maintaining the rules of diversification. In such a case he is burdening himself with a risk that carries no return behind such burden.

5 The Distinction Between Risk and Undesirable Consequences

An undesirable event is something whose occurrence we do not like. Risk is the likelihood of its occurrence. The occurrence of loss on an investment is something undesirable that we strive to avoid, but risk is the probability of the happening of what we fear will come about. Thus, the risk in drawing an insurance policy on the life of one who has crossed the age of 70 years is higher due to the high risk average, that is, the chance of his dying during the period of the contract is very high, as compared to drawing an insurance policy for a person who is in the prime of his youth.

6 The Relationship Between the Meaning of Risk and the Meaning of Uncertainty

Risk is related to a lack of certainty. Risk is the probability of the happening of one event whose occurrence is uncertain. As for certain events, they are not surrounded by risk. The existence of risk breeds uncertainty. The likelihood of loss in trade is a risk. When it does happen however, it is not reckoned as risk, but as something that does become certain. A fall in the market value of financial assets is a risk, but a decline in their value as a result of consumption (as a result of utilization or passage of time) is not a risk, because it is

[6] W.F.Sharpe, "Capital Assets Prices: A Theory of Market Equilibrium Under Conditions of Risk," *Journal of Finance*, 19:425–442 (September, 1964).

something that is bound to happen and is not probable. A return on investment is linked to risk through a relationship that is directly proportional.

The people are prepared to bear a high risk in their investments if these are accompanied by the probability of compensatory returns. They consent to a lower return if the risk involved is low. The investor is concerned with risk measures so that he does not bear a high risk in lieu of low returns. It is for this reason that people are in need of measuring risk, for the identification of the existence of risk is not sufficient rather it is necessary to identify the amount of risk and to ensure that the compensation is equal to the extent of the risk. Frank Knight elaborated, since the early part of this century, the distinction 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 is possible, but uncertainty is a situation when measuring of probabilities is either not possible or is not beneficial.[7]

7 The Importance of Risk Analysis in Financial Decisions

Risk analysis is the greatest common factor, more or less for financial decisions. The first priority for the person taking the decision, after he has determined the target, is to assess the forces that can possibly alter the course of events so that they can be prevented from reaching the target. The purpose of risk analysis is not the elimination of risk for that is an impossible task. The purpose is to identify the existence of risk and to be able to measure it so as to ensure that the person taking the decision acquires a suitable compensation commensurate with the extent of risk he is bearing. Financial decisions rely on the expectations about what is likely to happen in the future, except that the results of these decisions are not realized in a manner that was hoped for by the person deciding, unless events occur in the expected manner. Accordingly, the analysis of forces that can possibly lead to a deviation in events from their expected course is exactly what is indicated by the study of risk.

The effective factor in requiring compensation suitable for the extent of risk is that people in general incline towards avoidance of risk (are risk averse), that is, they always prefer minimum risk over more risk.[8]

7.1 Risk Management is not New to Human Life

Risk that people come across in their commercial activity is nothing new. Just as they recognize the importance of eliminating risk today and they strive in different ways to deal with it and manage it, the earlier people faced the same risk and assumed, as far as possible for them, the same objectives. Modern life, however, is totally different from the circumstances faced by people in the earlier days. Several elements have worked equally to make modern life less monotonous and move at a fast pace as compared to life in the early days. The earlier people lived in societies that suffered from immobility of residents and weakness of the means of transport and communication. Further, they relied on a

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[7] Frank Knight, Risk, *Uncertainty and Profits* (1921).

[8] Shapiro, p. 101.

system of exchange based on barter. Despite all this we find forms practiced by the earlier people that had risk management as the primary purpose. One such form is the con-tract of *salam* (advance payment) that was practiced widely in agricultural regions. The people of Madinah used to practice this contract when the Prophet (pbuh) was sent. He approved it for them and the *sharī'ah* laid down its detailed rules as well as the conditions of its validity and vitiation. It is evident that the contract of *salam* is intended to deal with the risk involved in fluctuating prices (price risk). The peasant proficient in matters of cultivation specialized in sowing, irrigation and harvesting, but he had no ability to deal with market risk for he had no experience in trading. By selling his goods by description, determined as a liability (usually his produce of wheat) he transferred this risk to those who had greater ability in dealing with it and these usually were traders. The *sharī'ah* laid down the rules of *salam* stipulating that it was not permitted to pay for specific goods like the produce of a particular field rather the subject matter of the contract were goods sold by description as a liability attached to the *dhimmah*. Thus, the contract of *salam* is specific to price risk. This step was taken only when this contract became a means for transferring natural risks like the risk of agricultural calamities and the absence of rain and so on, a fact that had converted the *salam* form into a type of gambling.

When life progressed, the means of livelihood became more complex, the types of goods and services, as well as means of earning multiplied and as activities generating a return increased, the risk surrounding these acts increased as well. The age of specialization and division of labour arrived, giving rise to a multiplicity of divisions and branches within these activities and operations leading to specialization by individuals and corporations working for determined incentives that engaged their entire time and strength. Competition led to an increase in such specialization. The result of all this was that a specialist in a field was unable to attain the same proficiency as that of specialists in another field. Thus, a trader specializing in the sale of cars, for example, could rise above others in this field, but he would not be able to attain the level of specialists in foreign trade or of those in dealing with credit risk.

8 The Function of Financial Intermediation

The basic function of banks, whether these are conventional banks or Islamic, is financial intermediation. By financial intermediation we mean the mediation by a banking establishment between the savers (group with a surplus) and between those who employ the funds (group with a deficit). The commercial bank performs the function of financial intermediation through borrowing from the first group and then lending to the second group. The Islamic bank, on the other hand, performs this function by accepting capital on the basis of *mudārabah* from the savers and then employing these funds in a number of transactions that generate debts or that are in the nature of participation. Part of the funds that are obtained by the Islamic bank are in the nature of debts (current accounts) that the bank borrows from the savers.

It is pointed out that what the intermediary establishments undertake is asset transformation in the following ways:

a) **Transformation of non-liquid assets into liquid assets:** The bank accepts cash deposits from the public and then draws on itself low risk instruments that the people employ in place of cash and these uncovered cash notes are converted into non-liquid assets.
b) **Transformation of short-term assets into long-term assets:** Claims on the financial intermediary have short periods on the whole (current accounts, certificates of deposit and investment accounts) whereas the assets of the bank have longer periods. Trading banks rely, in the generation of part of their receipts, on the method of distinguishing between borrowing on minimum interest due to short periods and lending with higher interest and longer periods.[9]
c) **Conversion of differing smaller assets into assets of huge pro-portions:** Financial intermediaries are a means through which the national economy is supported making possible the conversion of small savings into huge and effective capital sums. It is evident that the process of collecting numerous small savings for creating the working capital of huge corporations is beyond the scope of financial intermediaries as it is a process requiring enormous resources.
d) **Intermediation for diversification:** Diversification leads to the spreading of risk, but diversification is not available to the owner of small savings because of the difficulty of distributing them among different avenues. It is for this reason that financial intermediaries undertake the realization of this objective at low costs for small investors.
e) **Information:** Some economists believe that this is the most important function for financial intermediaries.[10] The reason is the existence of asymmetric information between savers and the employers of capital that renders the process of credit formation prior to lending and control, and the acquisition of information after lending with respect to a single saver, a process requiring enormous resources. As a result of the inability to identify credit worthiness of the borrower through a reasonable effort the savers always assume the minimum level of credit worthiness and will in future refuse to lend or will stipulate at the time of lending a higher rate of interest. The financial intermediary, on the other hand, is able to undertake the gathering of information and its analysis, as well as monitoring the acquisition of information is made possible due to economies of scale and because of specialization in this area.

It may be asked why the role of the financial intermediary is not confined to the sale of this service. The difficulty of verifying the various types of information available with the bank and absence of the likelihood of this, except by access to it, leads to the difficulty of converting this information itself into a service that can be accessed by the saver. It is for this reason that the work of the financial intermediary is based on bearing the risk on its own and confining the saver to bearing the risk of the bank itself due to the ease of leaving the decision to it on the basis of its experience and its record that is known to the saver. The commercial banks, therefore, borrow and then lend.

[9] Frank Fabozzi, p. 145.
[10] *Corporate Finance Theory*, p. 415.

9 Bank Control

Banks differ from all other commercial establishments with respect to their susceptibility to instability that affects their relationship with people for which purpose supervision by government institutions (like the central bank) is required so as to guarantee their proper conduct, adequate re-sources and stability. Perhaps, the causes of instability faced by intermediaries are:

a) The function of financial intermediation leads to the bank bearing huge debts that are many times more than its capital. There are the deposits of the public with the bank, whether these are current accounts or time deposits. It is known that establishments that carry heavy debts effect sharply the changes that occur in the economic environment in which they undertake their operations.
b) The function of financial intermediation requires that the bank existing as debtor and creditor derive the bulk of its profit from the different time periods and risks between the two sides of the relationship. It may, however, change into a form that makes it difficult to maintain a balance between the assets of and claims against the bank thus affecting liquidity, which is something that can lead to instability.
c) Reliance of the bank on the confidence that the people have in it. The bank cannot survive if this trust is disturbed or becomes non-existent. This is something that makes it vulnerable to the disturbances in the markets.

The principles and the goals of control over banks differ from one country to the other in accordance with the dictates of the conditions in each country and its financial and economic peculiarities. The goals of control in a general form, however, are:

- Ensuring that the bank is financially sound.
- Ensuring that the bank has a good and adequate management.
- That the bank tries to secure the interests of the depositors.

The external control body adopts practical measures to ensure that these objectives are realized. It, therefore, focuses through its control operations, on the following:

1. The extent of risk underlying each operation of the bank.
2. The existence of reserves, managerial skills, and economic resources that will enable the bank to manage risk (like the existence of sufficient capital, liquidity, and managerial skills).

From this it becomes quite clear that identifying the nature of risk underlying the Islamic forms of finance is extremely important because it is the means to a superior form of control that helps in ensuring stability of banking operations and an effective control on

the part of the central bank insofar as it protects the rights of those transacting with the bank.

10 Credit Risk

Credit risk is deemed the most important type of risk faced by the bank in its relationship with the owners of wealth. Credit risk is related to the probabilities surrounding the ability of the debtor to repay at the time appointed for repayment and in accordance with the conditions stipulated in the contract. If the debtor fails to abide by his obligations, it leads almost always to a loss for the creditor and it, therefore, becomes a risk that is faced by the bank. Credit risk is the most important type of risk faced by the bank in its operations that generate assets in the nature of debts and obligations towards others. The existence of credit risk is not dependant on direct financing of the bank like bank loans, rather the bank faces this type of risk in guarantees and acceptance paper when the source of the financial instruments owned by the bank is unable to meet its obligations (as in the case of bonds). So also in all indirect financing operations.

The risks faced by banks in their operations are of many types like interest risk, exchange rate risk and trade risk (or market risk), as well as those that represent changes in the rates of tangible assets and goods along with political risks and so on. However, the abilities and expertise available for managing risks are usually those for credit risk, and this is due to its importance on the one hand and the advanced skills of the bank for managing it on the other. It is for this reason that prudent bank management includes strict and detailed regulations specifically for credit risk with the purpose of controlling this form of risk and of managing it in a suitable manner.

11 The Place of Credit Risk in Banking Operations

Conventional banks face credit risk in almost all of their operations, be-cause the relationship between the banks and those who transact with them is that of a debtor with a creditor in all cases irrespective of the different terminology used for the contracts and transactions. The same is the case with Islamic banks for they face this form of risk in most forms of financing that these banks undertake. It is well known that *murābahah*, *istisnā*‘, and installment sale are sales with delayed periods of payment that generate debts in the accounts of the banks. The fundamental form of risk in all these is credit risk. From the contract of *salam* arises a trade debt rather than a cash debt, but it also includes a credit risk. *Mudārabah* and *mushārahah*, on the other hand, are contracts of participation, and the funds given by the bank to workers are not liabilities. Yet, these two also bear a credit risk in two ways:

1st: In the case of tort or negligence whereby the worker comes to guarantee the capital and it is converted into a debt liability. At the time of termination of the *mudarabah*, distribution and partition, the share of the bank is guaranteed by the worker, just like a debt. All this bears a credit risk.

2nd: When the funds of the *mudārabah* or *mushārahah* are employed for a deferred sale, which is what takes place in most *mudārabahs*, the owner of wealth (*rabb al-māl*)—being the bank in this case—bears an indirect credit risk. This risk pertains to the ability of the workers to repay.

12 The Significance of the Study of Credit Risk

Those who deal with Islamic banks observe that the burden of financing on the average is greater than the burden of financing by conventional banks. When we compare the cases of two persons one of whom has borrowed on interest from a conventional bank a sum of 100,000 riyals for a period of three years with which he buys a car costing 100,000 riyals while the other buys the car himself on the basis of *murābahah* with installments running over a period of three years, the second person will bear a greater burden than the former.[11] This means that the excess created due to the delayed period in *murābahah* is more than the interest on the loan. The sponsors of the Islamic banks do not deny this, but they respond to this with the following statement: Islamic banking operations carry a credit risk that is greater than that in conventional banks. When the relationship between the return and the credit risk is directly proportional, it is natural that the burden of Islamic financing be higher for supporting such risk. This is an issue that needs examination and consideration insofar as it gives rise to direct effects on the ability of the banks to remain competitive, and the effects on the policies of central banks in supervising and directing the Islamic banks.

13 Methods of Dealing with Credit Risk in Conventional Banks

Conventional banks have the structure and the means for risk management and its control that enable them to choose a suitable level of risk that the owners of the banks are willing to bear. Some of these are:

The conventional banking operations are based on the rule that risk and time are like goods that are sold and bought and that there are markets where it is possible to trade them freely. It is possible for each operative to place a suitable limit for himself on them, by means of sale, at any time he likes, to get rid of those that he does not wish to hold on to and to buy other risks that suit his aims and purposes.

The conventional banks have developed evolving modes in their policies for granting credit and for the management of risk. The following are by way of example and not an exhaustive list.

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[11] It is not proper for a Muslim to undertake a comparison between the *halāl* (permitted) and h . ar¯ am (prohibited) because a person who believes in God and the Day of Judgment has no option in this: “It is not fitting for a believer, man or woman, when a matter has been decided by Allah and His Messenger, to have any option about their decision” [Qur’ān 33:36]. But what we have mentioned is for the purpose of the study of the subject with which we are concerned. Although the loan carries a lower burden in the example offered it bears interest, which is prohibited *ribā*.

a) The strict regulations for giving credit are based on the credit worthiness of the client, his ability to abide by his obligations within the appointed time and the conditions agreed upon, and included in this is the financial reputation of the client and his credit history, financial standing, legal ability to raise loans from the bank, to negotiate either by himself or by delegation from his partners or his establishment where he works, and his ability to generate income in the future, because the repayment of the debt depends on his cash receipts and payments.
b) The taking of collateral and personal and tangible securities along with an emphasis on the ability of the bank to satisfy its claims from these in both its legal and practical aspects. Credit, however, is not granted on the basis of the strength of collateral and guarantees, but on the ability of the client to pay.
c) The economic circumstances in general and the special circumstances of the sector that generates the income of the client. The inclination and the ability of the client to abide by his obligations may be up to the desired level, but a change in the environment, in which the client operates, may force him to default or to procrastinate due to reasons that are external to his will.
d) The banks lay down strict regulations and policies for follow up and recovery either directly or through agents and collectors and law firms. The contracts of loans usually contain conditions that grant the bank the right to collect installments by any permitted means like authority over the other accounts of the client in the bank or even in other banks if possible without an injunction from the court.
e) Above all this the banks have developed forms for conversion of debts into cash and this is done by converting them into negotiable instruments that can be transacted or sold to third parties. This enables the bank to change its portfolio at any time and to choose the amount risk that is suitable for its circumstances and future needs. This is done by the sale of assets with an undesirable risk and to buy other assets in their place.

14 The Meaning of Risk From the Islamic Perspective

The meaning of the word *khatar* in Arabic is momentousness and significance, and from this is the statement that so and so is important. *Khatīr* is rashness and supervision over ruin. It is the prize that is assigned for those participating in a wager. Al-Zamakhshar¯ ý says in *Al-Fā'iq* that it is the prize set aside for the winner.[12] The meaning of *khatar* vacillates between existence and non-existence. The word has, however, acquired a new meaning in modern Arabic where it is now equivalent to the English word "risk."[13] The word became a new technical term in the discipline of Finance. It is for this reason that

[12] Al-Zamakhsharī, *al-Fā'iq*, vol. 1, p. 332.
[13] Some Western writers 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. For this reasoning see Ansell. . . .

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 were not prevalent in the early financial and trade transactions, like the risk in fluctuating prices, credit risk, and the risk of loss faced by investments. The reason is that risk exists in each contract that has to be performed in the future, and there is no doubt that this was known to them. It is for this reason that they defined the contract of *sharikah* (partnership), *mudārabah*, *salam* and so on as each of these contracts involves a transfer or the spread 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 today in modern financial transactions. Perhaps, the reason for this is that no methods for measuring risk were available to the 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 contracts according to the extent of the inherent risk and the inclusion of measures of risk in the process of decision making.

Although this meaning of the term *khatar*, being a new term, does not have a basis in the works of the earlier jurists on which the meaning can be constructed, yet we often find researchers on Islamic banking reasoning on the basis of well-known *qawā'id fiqhiyyah* (principles of *fiqh*) to show that a relationship of direct proportion is well-known in Islamic law between risk and return. Among these are principles emerging from the traditions of the Prophet (pbuh), "Entitlement to revenue is based on the corresponding liability for bearing loss" (*al-kharāj bi'd-damān*) or "profit is linked to loss." Along with these is the proscription from the Prophet (pbuh) about earning profit without a liability as well as transactions involving hazard (gharar). They maintained, on the basis of all this, that the owner of capital (for example) is entitled to profit in a *mudārabah* contract for he bears the risk, and that the lender has been prevented from taking an excess or profiting from a loan as he does not bear any risk. Further, the proscription from the Prophet (pbuh) about earning profit without liability for loss is an evidence that profit is not lawful without the liability for bearing risk, and so on. We will strive in a brief discussion to show that what is found in the works of the jurists to this effect is different in meaning from what is claimed in these arguments.

15 The Meaning of ***Khatar*** in the Terminology of the Jurists is What Arises from the Form (***Sīghah***) of the Contract

We have seen that risk in the financial sense consists of those forces that lead to a deviation in the path so that the contractual relationship does reach the expected goal. 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 the economic climate or dire straits 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 the bank advances a loan to its customer then this, by necessity, bears 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 claims 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.

As for the meaning of *khatar* (risk) in *fiqh*, it is related to the contract, and indicates the uncertainty that is generated by the contractual relationship. In the Islamic *sharī'ah* it is necessary that the contracts spell out clearly the rights and obligations arising from them and that the probability of each party reaching his object (goal) in the contract is similar. If they are covered by 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 *khatar* in *fiqh*.

All this is well-known in books of *fiqh* and we record here a minor transmission of Mālik from *al-Mudawwanah* in which he compares the two types of contractual relationships. The first he describes as risk and he says about the second that it is not risk, although both carry the same meaning of risk in financial studies.

- Mālik 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 and it is *mukhātarah*.
- Mālik 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 *mukhātarah*. It is something that he determined for him and their contract of sale was not based on this. This is how the case is settled by us.

What has preceded explains that *khatar* in the terminology of the 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 studies is linked to forces that govern the ultimate outcome of the contract. The difference between the first and second case above is legalistic. Financially, they are the same.

16 ***Al-Kharāj bi'd-Damān*** and Earning Profit Without Liability for Loss

The word *damān*, in the terminology of the jurists, has several meanings. The Shāfi'ī, Mālikī and Hanbalī jurists employ the word *damān* in the meaning of surety (*kafālah*) in the sense of merging one person's liability (*dhimmah*) with that of another in meeting obligatory claims. The Hanafīs use the term *damān* in the meaning of obligation to compensate in financial terms for an injury caused to another. The majority of the jurists, however, employ the term in the sense of bearing the burden of destruction (of the goods sold), and they deem it a condition for the validity of the sale after purchase. Likewise, the purpose of possession, according to the majority, is the transfer of *damān* (liability), that is the liability for bearing the loss due to destruction, from the seller to the buyer. 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 his sale was not permitted. The jurists rely in this on what is stated in the traditions: *al-kharāj bi'd-damān* as well as the tradition proscribing the taking of profit without liability.

Al-Shāfi'ī, Ahmad, the Compilers of the Sunan and al-Hākim have recorded by way of 'Urwah from 'Ā'ishah that a man purchased a slave during the time of the Messenger of Allah (pbuh) and he was with him for some time according the will of God. Thereafter, he returned him on the basis of a defect that he found. The Messenger of Allah (pbuh) decided 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 (pbuh) replied: *al-kharāj bi'd-Damān*."

The jurists disagreed about the chain of transmission of the tradition as well as its legal content. Ibn al-Qatlān declared the tradition to be sound as is stated by al-Hāfiz ibn Hajar.[14] Al-Zarkashī said that the tradition is sound, while Ibn Hazm said that the tradition is not sound. Ibn al-'Arabī has related from him in *Tuhfat al-Ahwadhī*, "*Al-kharāj bi'd-damān* is not a reputed tradition, but is a report about something that occurred, but whose outcome is not known."

Further, its *sanad* is not sound.[15] It is stated in *al-Qabs 'alā Muwatta' ibn Anas*, "Al-*Kharāj bi*'d-*Damān* is a tradition that is not sound."[16]

Those who uphold this principle argued for it on the basis of what is reported by Ibn Mājah in the tradition of 'Amr ibn Shu'ayb from his father from his grandfather of the saying of the Messenger of Allah (pbuh), "The sale of what you do not have is not lawful, nor is the profit of a thing for which you are not liable." They also rely on what is reported by al-Bayhaqī about the tradition of 'Atā' ibn Safwān ibn Ya'lā from Umayyah from his father who said, "The Messenger of Allah (pbuh) appointed Atāb ibn Asīd as governor over the people of Makkah and said, "I have appointed you over people for the sake of *taqwā*. No one is to consume the profit of what
he is not liable for . . . ."

The jurists argue on the basis of these two traditions for the rules of sale, especially in the case of the loss of the property sold prior to possession. The majority of them said, "The 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: Abū Hanīfah, Mālik and Al-Shāfi'ī said, "Entitlement to revenue is linked to liability for bearing loss." Again within the issue of the usurper of the benefits of an asset, Ibn Qudāmah says, "Those who do not impose lost wages (by way of damages) argue on the basis of the words of the Prophet (pbuh), "*Al-kharāj bi'd-damān*, and its liability is placed on the

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[14] *Al-Talkhīs al-Habīr*.
[15] *Tuhfat al-Ahwadhī*, vol. 3, p. 210.
[16] *al-Qabs 'alā Muwatta' Ibn Anas* li Ibn 'Arab¯ý, vol. 3, p. 324.

usurper."[17] On the basis of this reasoning, the lost wages are not awarded because he bears the liability.

The jurists 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 the Hanafīs not accepting the tradition of mussarrāt.[18] The reason is that this tradition conflicts with the principle *al-kharāj bi'd-damān*."

We, therefore, find that Abū Hanīfah did not accept the tradition of *musarrāt* as it conflicted with one of his accepted principles and it is a textual principle being a saying of the Prophet (pbuh): *al-kharāj bi'd-damān*, which has been related by Abū Hanīfah. The reason for not accepting the tradition is that the buyer bears the liability of this goat in case it dies in his possession. The milk is the revenue 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 Hanafīs, likewise, did not accept the tradition about discount due to calamities, because it goes against fundamental principles in their view and this is *al-kharāj bi*'d-*damān*. They also said that a contract of *mudārabah* by a *mudārib* (worker) is not permitted as this, in their view, is earning of profit without *damān*. Likewise, the contract of sub-letting by a tenant for he is earning a profit from something for which the liability is borne by the person who rented out the property initially. The Mālikīs adopted the other view despite the conflict with the principle of *al-kharāj bi'd-damān*,[19]because the tradition of mus . arr¯ at is stronger in their view.

Among the jurists are those who restricted the meaning of the tradition to food alone. Thus, Imām Ahmad as well as Ishāq ibn Rāhwayh were asked about profit without liability, and he said, "In my view this applies only to food, that is, food that has not been taken into possession, while Ishāq applied this to all that is sold by cubic measure and weight."[20]

Ibn Taymiyyah, God bless him, has mentioned this issue in his Fatāwā saying, "The later jurists from the school of Ahmad, along with Abū Hanīfah and the Shāfi'īs, uphold the interdependence of transaction and liability. Thus, in their view whatever becomes the liability of the buyer can be sold by him and whatever does not enter into his liability cannot be sold by him. It is for this reason that al-Shāfi'ī dismissed this in the case of the sale of fruit and did not uphold loss of calamities because the buyer if he takes possession

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17 Ibn Qudāmah, *al-Mughnī*, vol. 7, p. 418.

18 *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 *musarrāt*. A tradition says "Do not tie the udder of camels and goats. He who buys such an animal after this has an option after he has milked it. If he likes he can return it or if he dislikes it he can return it along with a *sā*' of dates." It is related by al-Bukhārī and Muslim.

19 *Al-Qabs*, vol. 3, p. 324.

20 *Masā'il al-Imām wa-Ishāq ibn Rāhwayh wa-Ahmad bi-Riwāyat al-Kawsaj*, p. 226.

and his transaction is valid the burden of liability will shift to him. The second view in Ahmad's school, as mentioned by al-Khiraqī and others from among the earlier jurists, which is supported by the principles of Ahmad's school, is that transaction and liability are not interdependent. Thus, the apparent view of Ahmad is that if the fruit is destroyed before the buyer was able to pick it, the liability for the loss is that it is permitted to the buyer to dispose of through sale, or otherwise. Thus, this sale is valid despite the fact that liability for loss is on the seller. He said, "Not everything that comes within the liability of the buyer can be disposed of on the evidence that the possession may not be valid." He added, "According to Mālik, it is permitted to sell a debt to someone other than the one who owes it, when the debt is not the liability of the creditor. This is a narration from Ahmad."[21] He then said, "The Prophet (pbuh) permitted the conversion of a debt in one currency for another when the currency is the liability of the buyer and has not been transferred to the liability of the seller. Likewise, the subject matter of sale, which is a debt arising from *salam*. It is permitted to sell it although its liability falls on the seller and has not been transferred as yet to the liability of the buyer." He said, "Supporting evidence for this are hire (*ijārah*) and fruit before it is cut. It has been established by a sound *sunnah*, which is not opposed by any other, that the price may be lowered for the buyer when the fruit is affected by calamity. Despite this it is permitted to dispose of it. If it is destroyed, the liability would be upon him to the extent of the price he has charged just as he is liable to the extent of the price he has paid." Thus, the linking of transaction with liability is not an unvarying principle according to Ibn Taymiyyah, but he did not permit the manner of disposal that would lead to profit without liability. Ibn Taymiyyah says, "The Prophet (pbuh) permitted conversion of the rate on the day of the transaction so that profit without liability is not earned. This is the text with Ahmad with respect to the counter-value of *qard* and other debts. All these have to be converted at the rate prevailing at the time of the transaction.[22] The reason is that if he had granted absolute permission without this restriction the transaction of exchange would take place at a rate other than the rate of that day and would lead to earning profit without liability. Thus, if the value of the debt owed to him was a *dinar* and the rate of currency exchange that day was 7 *dirhams* for a *dīnār*, but he makes the exchange for 8, that is, without reference to the rate existing at the time, it would be possible for him to take *dirhams* to the market and get one *dirham* plus one *dīnār*, which would be profit without liability.

Ibn Taymiyyah understood from this tradition that it prevents those situations in which profit is stipulated prior to the bearing of liability because of which it turns into profit without liability; this goes against the purpose behind the principle *al-kharāj bi'd-damān*. As for disposal in absolute terms, it is not prohibited because the realization of profit here is a mere probability.

It is possible to say *al-kharāj bi'd-damān* deals with a kind of risk that is inherent in all commutative contracts and this is the risk of destruction of the sold item prior to possession. The lawgiver, therefore, determines that the profit to be derived in such transactions be linked with liability (that is bearing the burden of the loss). Thus, if a

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[21] *Majmū' al-Fatāwā*, vol. 29, p. 398–401.

[22] Ibn Taymiyyah, *Majmū' al-Fatāwā*, vol. 29, p. 510.

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 the transfer of this special risk, arising from the destruction of property, from the original seller to the buyer and entitles him to profit. This conclusion, however, is not absolute due to two reasons:

First: The linking of profit with liability for loss is a matter of disagreement among the jurists. Some of them restricted it to food and whatever is similar to it, while others linked them to things sold by measure and weight. There is no doubt that the traditions of *musarrāh* and that for reducing the price on account of calamities indicate that the principle *al-kharāj bi'd–damān* is not a general principle or a principle that cannot be opposed.

2nd: That the meanings of *al-kharāj bi'd-damān* and the proscription about profit without liability have meanings different from what we have given for risk in financial transactions. The reason is that risk is related to the taking of decisions in reducing uncertainty. Just as the parties to a contract face a risk arising from the relationship created by the contract between them, the individual faces the risk of various types each time the meaning of risk is explored. The principle *al-kharāj bi'd-damān* is a 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 directly proportional relationship between profit and risk is an attribute for what exists and is a necessary proposition in all financial decisions. As for *al-kharāj bi'd-damān*, it is a legal text that determines the rights of the parties to specific financial dealings and is related to the burden of destruction that may afflict the goods that are the subject matter of the contract. Those who uphold this principle have linked the entitlement to profit with the bearing of this burden so that no injustice is caused to one party within the relationship by the other party by deriving a profit without bearing this burden.

17 The ***Gharar*** Sale

The word *gharar* means hazard and deception. In *fiqh* terminology it means something with concealed (uncertain) consequences.[23] It is something that vacillates between two things with neither being more obvious.[24] *Gharar*, according to Ibn Rushd, negates from a thing the attribute of coming into existence, being qualified and capable of delivery.[25]

The prohibition of the *gharar* sale is established in the *sunnah* that is related by Abū Hurayrah that the Messenger of Allah (pbuh) proscribed the *gharar* sale.[26] The Ummah arrived at a consensus on the prohibition of the *gharar* sale. The contracts of sale, however, do contain some form of *gharar*. The prohibition intended here, therefore,

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[23] *Al-Mabsūt* . , vol. 13, p. 194.
[24] *Sharh Muntahā al-Irādāt*, vol. 2, p. 145.
[25] Bid¯ ayat al-Mujtahid, vol. 1, p. 148.
[26] *Sunan Abū Dāwūd*.

applies to substantial not trivial gharar.[27] The examples they give of gharar are the sale of a bird in the air, a fish in water and so on. These are also called the sales of *khatar* and among these are the sale of the foetus, the lost camel and so on.

A resemblance between *gharar*, that has been prohibited by the *sharīʻah* by prohibiting *gharar* bearing sales, and between risk in the financial modern meaning does exist, yet there are differences between the two.

a) *Gharar* is a defect in the form of the contract that gives rise to a risk, but risk by itself does not lead to vitiation of the contract. As for risk in its financial meaning, it is something that relates to circumstances surrounding the operations arising from the contract, which sometimes demolish the objective aimed for by the person facing the risk.

   For example, when goods are sold for a deferred price, when these goods are present and are owned by the seller at the time of sale and the period of delay of the price as known and fixed at 5 years, the contract is valid, and does not involve *gharar*. The reason being that the rights and obligations arising from the contract for the parties are clearly stated in the contract. This contract, however, may carry a high risk in terms of its financial meaning, especially if the buyer has low credit worthiness, or the debt has not been secured through collateral or personal sureties. From a different perspective we examine a sale with deferred price, but this price is linked to a financial index like LIBOR. Thus, when the time for payment arrives the amount will be determined finally on the basis of this rate. There is no doubt that this contract bears a risk that is lesser when compared with the contract in which the deferred price is fixed and does not change. However, tying the price to an index involves substantial *gharar* for the contract and it renders it void, even though the risk is lower. The deferred price that is fixed involves insignificant gharar although the risk is high.

   Accordingly, it is possible for us to say that *gharar* has a meaning that is different from the meaning of risk in its financial sense, even if there are some similarities. *Gharar* pertains to the contractual relationship, and it may or may not exist depending on the form of the contract. Risk, on the other hand, pertains to the circumstances surrounding the contract.

b) *Gharar* has a fixed meaning and, therefore, if a contract is concluded without *gharar*, no *gharar* can affect the contract later. In the example that has preceded, if the debtor dies, we cannot say that the contract now contains *gharar* and it should be declared void after being valid.[28]

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[27] The examples of trivial *gharar* are parts of a cloak, household goods and so on.

[28] If, however, the period of the debt was 50 years it would be a contract with *gharar*, because the debtor would not be safe from dire straits or death in the period of 50 years.

18 Credit Risk in Islamic and Conventional Banks

Someone comparing the accounts (financial statements) of Islamic banks and conventional banks will find that the assets side of both essentially consists of debts. Although it is assumed that Islamic banks are concerned with other forms of financing like *mudārabah* and *mushārakah*, but in reality they focus on *murābahah* and *istisnā*'. Perhaps the justification for this is that banking skills for managing credit risk are highly developed and it is possible to utilize them, whereas risk management for *mudārabah* and *mushārakah* is yet in the early stages of development and growth of procedures for it will come out of indigenous efforts without relying on support from the experience of conventional banks.

Nevertheless, banking debts held by Islamic banking are different in nature from those with the conventional banks. This fact has a significant impact on credit risk. Among these are:

a) **No Possibility of Increase in the Debt Once it is Established as a Liability:** Loans in conventional banks have repayment periods and the debtor is under an obligation to repay what he owes to the bank at the end of the period. He is considered a defaulter if he delays this payment without the agreement of the bank. If, he delays the payment or becomes a defaulter the debt against him increases in proportion to the extended period. The debt is called a performing debt if the interest is generated continuously. The banks rely on what is called rescheduling of the debt in cases where the customer is unable to make the repayments on the appointed time but is inclined to maintain a fruitful relationship with the bank and is prepared to bear a higher rate of interest. This, however, is the essence of *ribā* of *jāhiliyyah* the prohibition of which is agreed upon and is indicated by the well-known statement made by the debtor saying to the creditor, "Increase the period for me and I will increase the debt (amount) for you," or the statement of the creditor, "Will you pay me or increase the amount." Accordingly, there is possi-bility of this type of operation in an Islamic bank. If the debtor, who has bought immovable or movable property from the bank, by way of *murābahah*, *istisnā*' contract, *ijārah* or *iqtinā*', delays the payment, the bank has no right to increase the amount by imposition of penalties for delay. Some Islamic banks that impose penalties for delay do so by way of deterrence, and then give away the amounts so collected by way of donation and charity, because it is not permitted to the bank to benefit from this flow by registering it as a source of income. These banks do not restrict their activity to this rather they adopt other measures with the purpose reducing the impact of this problem on the bank. Among these are:

i) Increasing the rate of mark-up in the price. This is added to the delayed price relying on an assumed pattern of the customer. This pattern is that of defaults in repayment. It results in the deferred price imposing a much greater burden as compared to a loan.

ii) Determining transactions on the assumption that the customer is bound to default on payments and to keep the price very high and on the basis of

additional delay, two payment schedules are created. If the customer pays according to the first schedule, a part of the increased price is returned to him. The second schedule is with delay and under this the entire price has to be paid.

Will the Denial of Excess in the Amount of the Debt After it is Established as a Liability Raise the Level of Credit Risk?

It is not possible to state as a fact that denial of adding an excess to the debt will necessarily lead to an excess in the credit risk. The reason is that the purpose of this excess is to deter default and it is not a valid means of increasing profits.

The level of risk is dependent upon the types of customers and the types of choices they make. Considering the circumstances under which most customers delay payments, it does not benefit the bank to impose excess amounts on them for they will delay the payment of these excess amounts too. Further, it cannot be said that the bank can recover these amounts by foreclosing on the mortgages, because this does not work except in rare circumstances and not as a general rule. As the purpose of the excess is deterrence, the existence of penalties imposed on the customer and that are distributed by way of charity and welfare, and this is easy for the Islamic banks, they are sufficient to bring the level of risk in *murābahah* to the same level as that found in loans given by conventional banks. The experience of different banks has shown that the credit risk in *murābahah* is not different from loans from this perspective.

b) **The Effect of the Form of the Contract on the Level of Risk:** The fundamental difference between the model of Islamic banking and the model of conventional banks is that the latter works on the basis of loans. The relationship between the bank and its customers, irrespective of the name of the transaction, is a relationship of a creditor with a debtor and between a lender and a loanee. As for the Islamic bank, it operates through sales, partnership and leasing. Some people have assumed that this means that the risk in Islamic banking operations is by definition higher than that in conventional banks. The truth is that this point of view is incorrect because it cannot be said that the category of loans bears a lesser risk as compared to the categories of sale, partnership and leasing. Therefore, the efforts of Islamic banks to conduct all of its operations within the ambit of *murābahah* does not by necessity lead to reduction in the amount of banking risk, just as dealing in loans also does not mean low risk.
c) **The Prevention of Trading in Debts:** The sale of a debt to someone other than one from whom it is due, before its maturity, for less than its face value, is prohibited. This closes the door on trading in debts. Islamic banks cannot, therefore, deal in discounting of bills as this turns into *ribā*. More important than this is that it is not possible for these banks to rely on transferring debts in their books by way of sale to other parties. The method of portfolio optimization enables the bank to restructure its assets in the portfolio and this without doubt leads to an ability to manage risk in a better way. This, however, is not possible

for a bank whose major assets are debts except by sale of such debts. If the sale of debts is prohibited as is the case in Islamic banks, these banks require flexibility in managing risk. It is, however, not something related to credit risk rather it is related to liquidity risk.

d) **Non-permissibility of Conditional Discounting:** Many customers desire the satisfaction of their debts prior to maturity. This is sometimes the best solution for them as well as for banks. When they do this they rely on the texts on the stipulations for a loan contract that indicate the amount of discount available if the customer were to do so. This type of provision allows the possibility of managing credit risk in a manner that is suitable for the bank. However, this method is prohibited for *murābahah* although there is nothing to prevent early satisfaction and there is also nothing to prevent the giving of discount for early payment. But stipulating this in the contract is not permitted. Some have believed that it becomes a cause of a risk of reliance on the bank.

19 The Cause of a Higher Level of Risk for the Islamic Bank

It is obvious from what has been presented earlier that the forms of instruments permitted to conventional banks, which they employ for risk management, are not all permitted to Islamic banks. What this means is that the ability of Islamic banks of dealing with credit risk or rates of profits risk (interest risk) as well as the means available to these banks for balancing claims and assets, are limited. The cause of all this, however, is the reliance these banks have placed on *murābahah* as being almost the only form of financial intermediation. The contracts of *murābahah* have reached a level that is more than 90% of the operations of several banks. So much so that those that have been successful in employing other forms are found to focus on forms that give rise to debts like *istisnā*‘. Considering the fact that the financial assets generated through *murābahah* are debts, the permitted possibilities of dealing with them within the permissible limits set by the *sharī*‘*ah* are limited.

Murābahah made it possible for *al-‘āmir bi-al-shirā’* to utilize the experience of conventional banks within the ambit of accounting and financial management because it gives rise to assets that resemble those that are generated by bank loans. This led those dealing with Islamic banks to compare the burden of financing through *murābahah* with the burden aris-ing from bank loans because each in the end is a debt, and this in turn led to the conclusion that the operations of Islamic banks carry a heavier burden than bank loans. In addition to this, focusing on contracts of *murābahah* deprived these banks of benefiting from possibilities permitted by the contract of *mudārabah* and the various types of contracts based on *mushārakah* and *ijārah*. Perhaps, the most important cause of this is that Islamic banks compete in markets that have conventional banks (operating in them too).

There is no doubt that *mudārabah* and *mushārakah* in all their types bear a higher risk than the usual forms of risk. The reason is that these forms rely in addition on the circumstances that surround the decisions and the trustworthiness of the customers of the bank with respect to commercial activity. Thus, if the ethical standards of the client are

lower than the desired level, the attainment of the objectives desired from the investment is not possible. However, the distinctive feature of these contracts lies in their ability to gather all forms of risk and to include them in the profit generated.

Capitalist economies consist of two sectors. A real sector in which profits are generated from labour and production, and this is the source of risks that carry losses on investments. The other is the financial sector and this is composed essentially of financial intermediation. Their primary function is to restructure the burden or risks and to spread them in a manner that attracts funds for purposes of investments in the real sector as well as to provide opportunities to savers in choosing risks that they are inclined to bear. While the clients of the banks in the capitalist system strive to segregate the real sector from the financial sector, the Islamic banking model undertakes to ensure the integration between the two sectors. An empirical examination of the contracts permitted in Islamic banking operation makes it absolutely clear that the most important effect of contracts prohibited in all financial transactions is to cause a split between these two sectors.

Financing in itself is a real activity as it leads to an increase in the ability of the real sector to produce as well as to integrate the financial capital with the real sector. It attempts to achieve this result irrespective of the financing being on the basis of *mudarabah*, *sharikah*, *murābahah* or debts. The sale of these debts, or trading in them, or discounting them prior to maturity, is all financial activity that is not real in the economic sense. The same is the case, in our view when the amount of debt is increased in lieu of an increase in the repayment period. The existence of such transactions gives rise to the financial sector. The question then is whether it is possible for an institution of financial intermediary to manage risk within the domain of the real sector?

In other words, is the financial intermediary that operates within the do-main of permitted transactions, and its activity is restricted to the real sector, able to manage risk to an extent that will permit it to compete with conventional institutions? The source of all risk is the real sector be-cause the profits that we reap by bearing risks are to be found in this sector. The pure financial transactions that are the innovation of the own-ers of conventional banks do not deal with the risk existing in the real sector for it is separated from it, rather it strives to rearrange the spread of this risk and to transfer it from one location to the other, that is, to a place where the investor is prepared to bear the risk in lieu of a return. Is it then binding that all this take place through prohibited contracts?

20 Conclusion and Findings

It is possible to say that Islamic banks in their present form representing predominantly huge debts as bank assets are faced with risks that have a higher ratio as compared to those faced by conventional banks. This is because they rely on methods for dealing with risk on debts that operate within the confines of the permitted. It is obvious that the operations of Islamic banks at present focus on debts and that the possibility of managing risk in this context is limited taking into account the restrictions placed by the ah . k¯ am (rules) of the *sharī'ah* on financial transactions.

We cannot, however, acknowledge that the model of Islamic banks must face a higher level of risk. This model, in which debts form trivial part of the total assets and which is based on an investment portfolio that includes the various types of partnerships and contracts of *ijārah* and *mudārabah*, includes possibilities of operating within the permitted ambit of the *sharī'ah* to adequately deal with the sources of risk.

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Credit Risks in Islamic Bank Finance (Discussion)

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1 Introduction

After prayers and blessings on the Prophet, we thank the learned Doctor for this excellent paper, for the obvious efforts he has put into it, for the valuable opinions and information that he has recorded, and the numerous references that the Doctor has relied upon, so much so that the paper has become comprehensive dealing, in our view, with all aspects of the topic of research.

The paper begins with describing the meaning of credit, the concept of risk in financial transactions, the importance of and manner of financial analysis for identifying the size of the risk in financial discussions. The purpose in this is not the elimination of risk, but the identification of its existence and measurement so as to enable the person taking the decision to take a decision compatible with the extent of the risk, therefore, the management of credit risk.

The Author then moves to the function of the bank as a financial intermediary and in this function the conventional banks and Islamic banks stand on the same footing. He then begins the detailed description and analysis of each aspect related to credit risk, its definition, study and methods of treatment in conventional banks, the importance of the role of supervision over banks by the central bank to contain the efforts of their risk as well as to give stability to the bank. Thereafter, he deals specially with substantial and important aspects of risk from the Islamic perspective.

The paper is comprehensive, as we stated, but it focuses mostly and in a detailed manner on risk in its traditional sense. Perhaps this was necessary to give a background to its relationship with Islamic bank finance. There is nothing wrong with this, yet we would have expected a similar focus on risk in Islamic banks.

No one denies the existence of credit risk and the significance of dealing with it for it is risk that is present since the earliest times. The Glorious and Exalted says in the revealed Book: “Among the people of Book are some who, if entrusted with a hoard of gold, will (readily) pay it back; others, who, if entrusted with a single silver coin, will not pay it unless thou constantly stoodest demanding.”[29] The Noble Qur’ān reminds us of the risks in financial dealings in a period when there were no banks and financial transactions were not undertaken through institutions, but as transactions by individuals. Allah, the Exalted,

[29] Qur’ān 3:75

informs us that among the people of the Book is a group who are to be trusted with big or small sums, like ʻAbd Allāh ibn Salām with whom a person from the Quraysh deposited 1200 *awqiyahs* of gold and he promptly returned this. Among them are also those who will violate the trust even if it is small and recovery from them becomes difficult except by continued demands and requests or even through a judicial pronouncement and the production of evidence against them like Kaʻb ibn Ashraf with whom a person deposited a *dinār* and he disputed with him and violated his trust.[30]

This is what the Qur'ān tells us about something to which the term credit risk can possibly be applied in our modern times and that has to be reckoned with and avoided.

The Author of the paper emphasized this and no one will differ with him on this. There are, however, some aspects on which we would like to focus for purposes of discussion.

2 Financial Intermediation

In what pertains to the function of financial intermediation the position of Islamic banks and the conventional banks in similar but the two are not exactly similar. Besides this, we would maintain that the sources of the Islamic banks comprising current accounts are not obligatory in their commonly understood meaning even though they take the form of a loan. These are deposited with it as a trust and their repayment is obligatory on demand. It is, however, permitted to the bank to employ the amount for the duration between their delivery and the time that the owner demands their repayment to him. Likewise, the bank, contrary to what is stated in the paper, converts the deposits and these are claims (according to the accounting concept) that are liquid/frozen up to current assets that are the least liquid. It is not as has been stated in the paper that they are "frozen assets."

Despite the services of financial intermediaries undertaken by the banks with respect to transforming liquid claims into assets that are less liquid, the gathering and transformation of small savings into huge assets, the spread of risk and being a storehouse of information related to investment and risk, they are in themselves the location of risk from the perspective of depositors. When a depositor decides on his own to deposit his savings with a particular bank and not another bank, he is doing so on the basis of evaluation of the different types of risks that his deposits will face. He does this despite the difference in sources from which he derives information about the status of the bank and the adequacy of its management, or its history. He does this despite our knowledge that this risk is highly insignificant taking into account the high standard of transparency that is the attribute of banks in our present times and the concern of monetary authorities for the security of banking practices from all aspects financial, managerial and legal.

3 Bank Control

[30] Wahbah al-Zuhaylī, *al-Tafsīr al-Munīr*, vol. 3, p. 246.

In its comprehension of the role of control of banks, the paper focuses on the importance of ensuring the existence of financial security for the bank as well as a good management with high professional skills and that the bank should secure the interests of the owners of the deposits. The paper does not consider other aspects of the role of bank control. The Author of the paper possibly overlooked these aspects because the primary subject of the paper is the management of credit risk. On the other hand, the paper means by control and investigation (audit) on the part of the internal controller or the external auditor. Bank control, in our view, is more comprehensive and deeper than this. By this control we mean that undertaken by monetary authorities—the central bank—with the emphasis that its monetary policies that regulate the general economy are followed as a matter of obligation by trading and specialized banks and other financial institutions. It is possible to fix the goals of monetary policy as the combating of inflation, stability of the general level of prices, stability of the exchange of national currency, justice in the distribution of national income, and the boosting of savings. To achieve all this the central bank employs different means. Among these are:[31]

1. Linking money supply with the size of the targeted liquidity that is determined annually through the central bank in accordance with the levels of national economic growth and levels of inflation.
2. Directing resources in accordance with the priorities stated in the financial policy issued by the Bank of Sudan.
3. Protecting the financial security of banks.
4. Ensuring the realization of justice in the distribution of income and banking services.
5. Assuming the Islamization of banks.

The Central Bank issues directives in its annual report detailing therein the financial policy mentioned at (2) above. This policy includes the following:

1. Determining the credit ceiling for each bank
2. Distribution of this ceiling for financing priority sectors like agricul-ture, manufacturing and services
3. Allocating a determined percentage of the resources of the bank like cash reserves, etc. to other avenues.

The central focus of control on the part of the Central Bank is on ensuring the implementation of the targets of the monetary policy in which are employed these means and directives laid down in the financial policy.

Most of these instruments and financial policies—if not all—touch upon credit in one form or another. For example, determining a specific ceiling and its distribution among sectoral ceilings can sometimes lead the bank to finance activities with a very high risk for securing a higher return. At other times it can lead it—as stated in the financing of

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[31] Dr. Muhammad Hasan Sabir, *Islamic Monetary Policy*—paper submitted at the con-ference on Sources of Economic Activity.

agriculture—to financing activity that is not eligible for measuring credit risk, and consequently it can lead to heavy losses for a bank.

Likewise, bank control lays great emphasis on the fact that all financial operations undertaken by the bank should be carried out in conformity with the *shar*‘ī rules. Non-conformity with *shar*‘ī rules also constitutes a credit risk, for the bank can suffer a loss if a dispute arises between the bank and one of its clients due to conflict with the rules of *sharī*‘*ah*. The Organization for *Shar*‘ī Control can annul the operation after the bank has invested some funds in it. It is for this reason that Bank of Sudan has stressed in its policies that the banks in Sudan benefit from highly qualified cadre of experts.

4 ***Murābahah*** Risk

The general opinion is that credit risk is higher in Islamic banks than that in conventional banks.

We begin with *murābahah*. We find that determining a margin of profit (in *murābahah*) does not depend upon time alone, but on a number of factors, the most important of which is the role of goods as the subject matter of financing within the context of their marketability. This is in addition to the marketing skills possessed by the client to market the goods, if the goods are a part of the trading goods or are utilized to generate income. Whereas, the aim of determining the margin of profit in the case of conventional banks is based on the rate of interest that is determined beforehand. The conventional bank is only obliged to apply this rate for the period of need in addition as other guarantees. Thus, a similarity between financing by Islamic banks and that by conventional banks basically does not exist, because the operation in *murābahah* is an operation of sale and purchase even if the two operations are similar in implementation. However, keeping in view the sway of thinking about rib¯ a for a long time over the minds of most Muslims and others, the Islamic banks will continue to undertake this comparison or look at this similarity for a period that is likely to be lengthy.

The paper has pointed out that some of the Islamic banks calculate the deferred price on the basis that the client will default on the repayment. Therefore, the price places a higher burden (of financing) as compared to financing by conventional banks, however, when the client pays up in the shorter period, the excess price charged will be reduced to him. This excess resembles “discount on early payment” and an underlying understanding that there is a prior agreement between the bank and the debtor that if he pays earlier the excess will be returned to him.

The question that arises here is as to what is the basis upon which this excess is based? Has it been worked out on the analogy of financing on interest that is prevalent today? How close does this come to *ribā*? These operations are not being practiced in the Sudan.

It is well-known that in Islamic transactions in case the debt is established, it is not possible to increase its amount in lieu of a delay in repayment. The Author of the paper has stated that preventing an excess in debt after it is established does not by necessity

lead to an increase in credit risk. He maintains that the level of risk depends upon the type of clients and the choices they make. While we agree that the type of clients and the correctness of their choices is a fundamental element within the constitution of risk, we do not agree with him that the existence of penalties, which the Islamic banks impose on their clients and their spending by way of charity, is sufficient to render the level of risk in *murābahah* equal to its level for loans in conventional banks. We would say that the excess over the principal amount of debt, that is, the penalties, are imposed on the clients by some banks and not all. For example, this is not the practice in Sudan, despite the fact that some of the jurists in Sudan have permitted that and so much so that they have permitted the banks to treat the penalties as their normal income. The non-implementation of this refers to the accusations and blame this may give rise to like the ambiguity surrounding the basis upon which the rate of excess structured and the lack of verification of procrastination by the debtor not taking into account his dire straits as well as the fear that this may become the normal practice that will bring it within the ambit of prohibited *ribā*.[32]

There is another concealed risk in not increasing the amount of the debt. This is the risk of a fall in the value of the currency and the excess that is included in the rates. There is no doubt that in this case the receipt of the bank will be lower and there is nothing it can do to avoid this. The reason is that the debt must be returned by similar (*mithl*). The Council of the Islamic Fiqh Academy issued the following resolution in 1988:

> The satisfaction of debts established in a currency have to be in similar (source) currency and not by value, because debts are satisfied by similars (*mithl*). It is, therefore, not permitted to link debts established as a liability, whatever their source, with the level of rates . . . . God knows best.[33]

5 Risk in *Mushārakāt*

It is well-known that the philosophy and methodology behind the operation of an Islamic bank differ from those of a conventional bank with respect to the approach of each towards the financial system and transactions within it. The conventional bank considers currency as a commodity that can be sold and purchased and the rate of interest is the price that expresses the value of the currency. The Islamic banking system, on the other hand, sees currency as an instrument that performs a function and the value of the function is not determined except after the performance of the function. There is a sharp difference between the two systems. While the conventional banks know beforehand the return on financing that is undertaken for corporations in all its various ways, the Islamic banks came to know about the return only after the realization of the result of the operation.

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[32] Mawlānā Ahmad ‘Alī ‘Abd Allāh.

[33] Resolution No.(4) dh/9/1988 issued by the Islamic Fiqh Academy in Jamādi ’l-Ūlā, 1409, on 15th December, 1988.

Types of *sharikāt* and multiple *sharikāt*. These begin with *sharikāt* if a short duration and end up in corporations that are perpetual. It is the process of exchange of goods, which determines the price of the function of currency that the Islamic bank is subjected to profit and loss just as it becomes subject to the law, to which usually the seller and buyer are subject, so also it is subject to the risk of trading and the liability of the partner (shareholder).

The risks of financing the different types of *sharikāt* are numerous. They differ with the variation in the form of investment its role and periods. The risks also differ because of the size of the investments and duration, and sometimes due to the investment environment and the technical nature of the investment.

The Risk of *Shar*'ī Financing Arises Due to a Number of Factors.
The most important are:

1. The absence of precise standards for seeking information about the clients that would clarify the eligibility of the client for *mushārakah* with the bank. This often leads the bank into projects that have a very high level of risk.
2. In most forms of financial transactions, especially in *sharikāt*, the element of trust (*amānah*) plays a major role. We, therefore, find that the sureties that are demanded are confined to cases of wrongful acts or negligence. For doing away with risk, the Islamic banks turn in addition to the investigation of the financial status of the client, his managerial activity, and the capacity to abide by the legal and ethical obligations. Because the bank becomes a partner of the client and bears with him the positive as well as negative consequences of the activity it also tries to study very minutely the market from the perspective of sales, the availability of goods and the competition faced in the near and distant future. It places its trust in the project and continues to follow the progress of its partner.

All this is not negated if the banks participate in long-term projects and take up the formation of a number of corporations (*sharikāt*) which are subject to the civil law and to a number of taxes and incentives. This is due to the possibility of its sources of earning being unlimited as against the conventional bank that has only the pre-agreed interest as its income whether the project suffers a loss or makes a profit.[34]

If the Islamic banks come to own limited liability companies that are its subsidiaries up to a hundred percent, the risks become confined to the capital invested by way of participation in these companies. The risks are then subject completely to the fluctuation of the market economy policies and environment.

As for *mudārabah* partnerships, the containment of risk is confined only to the liability for wrongful acts and negligence. The stipulation of liability for the *mudarib* (worker), for the loss of capital without transgression, or due to losses that may occur through the operation of the *mudārabah*, will render the contract void (vitiated) as is recorded in the

[34] 'Abd al-Rahmān Muhammad al-Nāfi*', Mas'ūliyyat al-Bank al-Islāmī 'an al-Darar al-Nātij 'an A'māl al-Sharikāt* (Matbū'āt Nadawat Bank al-Tadāmun al-Mutakhassasah).

views of the Mālikīs, Shāfi'īs, and Hanbalīs,[35] just as it will be vitiated by stipulating a fixed amount (as profit) for one of the parties. This means that the bank cannot stipulate any condition that can compensate it for its losses. Dr. Sāmī Hamūd has, however, stated that if the *mudārib* pays out the capital of the *qirād* to another worker, he will be held liable for losses. Some other scholars have, however, deemed his view to be incorrect insofar as this is only possible where the transaction has been undertaken without the permission of the *rabb al-māl*. Through an analogy from this we infer that if the bank gives out the money of the depositors for *mudārabah* transactions, it can only be with permission of the depositors.[36]

6 Summary

On the whole, containment of risks of Islamic bank finance is possible through a number of avenues. The important avenues are:

1. Detailed examination of projects presented for financing from all aspects: technical, economic, and marketing. The bank should build a database in which information on all these aspects is stored from the perspective of the various investment activities.
2. Gathering of detailed information about those who transact with the bank from the perspective of managerial skills and fairness of financial dealings as well as soundness of character.
3. The employees of the banks should be professionally and technically sound. They should be imbued with an Islamic character and should perform their professional functions diligently. They should be knowledgeable, have a sound moral character, be proficient in their work, truthful and trustworthy. They should be able to subject themselves to self-criticism and resist the temptations of wealth.[37]
4. The matter of utmost importance is that the majority of those who transact with banks should join them in building an Islamic environment based on truth, trust soundness of management based on truth and a complete mastery over their projects.

[35] Dr. Hasan 'Abd Allāh al-Amīn, *al-Mudārabah al-Shar'iyyah wa Tatbīqātihā al-Hadīthah*. A publication of the Islamic Development Bank.
[36] Ibid.
[37] Dr. Ahmad 'Alī al-Imām. A study presented to the conference on Economic Activity.