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CREDIT RISK IN ISLAMIC BANKING AND FINANCE

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ABSTRACT

The concept of risk was well known in ancient societies. Even in financial decisions, people knew very well that lending to someone who is bankrupt has a high probability of losing the money as compared to a debtor with good standing. Nevertheless, risk became an important tool of decision-making when it became possible to measure it and to assign values to different situations. This paper argues that the concept of risk mentioned by jurists in their studies on the theory of contract has nothing to do with the concept of risk as known in modern financial studies. Such a distinction is important because when jurists refer to certain "risky" contracts and render them unacceptable from the Sharī[ah point of view, some practitioners of Islamic finance take it as referring to risk in the jargon of finance. That is not correct. We should benefit from the great advances in studying risk and risk management techniques in finance. However, we have to develop our own theory that deals with the unique concept of risk from an Islamic perspective. This paper is an attempt in that direction.

1. THE IMPORTANCE OF THE TOPIC

In the past, theoretical studies on Islamic banking have focused on Islamic modes of financing and their ability to perform financial intermediation for catering to the needs of people so as to be substitutes for loans while ensuring the compatibility of these modes with laws regulating banking operations. Banking supervision, however, has not received its due share in these studies. It is well known that banking supervision is concerned with various aspects of risk in banking operations. As the bank is a trustee of public funds, it is incumbent upon it to utilize these funds in ways that protect the rights of the owners of these funds. Therefore, comparative studies on risk underlying Islamic modes of finance are extremely important. They promote a sound understanding of various aspects of Islamic banking operations, an understanding that is needed by supervisory institutions. Likewise they encounter an objection that Islamic modes of finance carry much higher risks than interest-based loans.

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2. THE MEANING OF CREDIT

The term "*Al-I'timan*" is correctly used by economists to denote the meaning of the banking term "credit". In some dictionaries, the following meanings are given under the term credit:

> It is the belief held by people that a certain person is wealthy [1].

The author of the dictionary adds:

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

This exactly is the meaning of *i'timan*. It is incorrect to state that *i'timan* means 'granting a loan'. *I'timan* is the confidence reposed by the bank in someone before it is prepared to grant a loan or provide a guarantee. Accordingly, loan is dependent on this confidence and is a result of it. Guarantee is part of what is termed credit in banking jargon and is based on the same "confidence." In some banking dictionaries, it has been defined 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]

3. THE MEANING OF RISK IN FINANCIAL LITERATURE

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

Mukhatarah (risk) is defined by one writer as "the situation that involves the probability of deviation from the path that leads to the expected or usual result."[3] Another writer states that in simple terms it means "the likelihood of loss."[4] Risk is present in all acts undertaken by human beings; but it acquires special significance

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[1] Khalīl Shaybūb, *Mu'jam Qānūnī* (1949).
[2] Downs (1991).
[3] Vaughan (1999), p.7.
[4] Megginson (1997), p.95.

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, try 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. These include statistics, economics, financial management and insurance. Examination of risk in each of these sciences has specific aspects that differ from those in others. Despite the intricacies that surround the discussions of risk, its meaning does not go beyond what has been stated above. The purpose of studying risk is not its elimination because that is not possible. The purpose is to acquire some control over it and to manage it in a way that reduces its harmful effects in decisions that we need to take.

4. MEASUREMENT OF RISK

Risk has no practical significance if it cannot be measured. As the meaning of 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 outcome has various grades. The risk of being affected by diseases of lungs faced by a person who smokes 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 with two bullets in revolver, 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 developing criteria for measuring risk and for classifying it in a manner that enables its identification clearly. These 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 measuring and classifying risk and there are institutions that specialize in this job. Banks and insurance companies have also developed special ways of measuring risk. If an investment opportunity bears a higher risk, it does not mean that people will not accept it at all. They might, provided it is possible to measure the risk and that risk is accompanied by returns that are considered adequate for that level of risk. People will, however, avoid investment opportunities that involve ambiguous and unclear risks. This ambiguity is itself a form of risk. Thus, investment for which risks are not clear will be reckoned as being a high-risk investment.

Human efforts for measuring risk go back to the seventeenth century when Pascal, the famous mathematician, discovered the theory of probability and then the law of large numbers that enabled the utilization of abundant information of the past to predict what will happen in future, natural distribution in statistics, and

coefficient of correlation. All this led Harry Markowitz to establish in 1959 that it is possible to reduce risk in 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 as well as 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. Risk in a portfolio will be less, lesser the correlation between the returns on the assets included in the portfolio. He called this idea, "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 total elimination through the process of diversification indicated above, while the second element of risk must be borne by the investor. The theory of portfolio selection is an art of maximizing returns while reducing the risk involved. From a different perspective, the correlation between different investment instruments (forms of investment) becomes an important element. It is not possible to evaluate various instruments in isolation from one another. Each instrument acquires its importance in proportion to its contribution to total return of the portfolio. It is for this reason that application of Markowitz's theory requires a thorough understanding of averages, measures of variation and coefficient of correlation for all the assets that can possibly constitute the portfolio.

The next development came at the hands of Sharpe.[6] He established that the investor acquires a return in proportion to the element of risk that cannot be eliminated by means of diversification. If someone expects a return on risk that he cannot bear or to get rid of as far as possible, he fails by necessity, in applying the rules of diversification. In such a case he is burdening himself with a risk that carries no return.

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. Thus, the risk in drawing an insurance policy on life for someone who has crossed the age of 70 is higher due to a higher chance of his dying during the period of the contract, as compared to an insurance policy for a person who is in the prime of his youth.

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[5] Markowitz (1959).

[6] Sharpe (1964).

5.1 Relationship Between the Meaning of Risk and the Meaning of Uncertainty

Risk is the probability of happening of an event whose occurrence is uncertain. As such events that are certain do not involve any risk. It is uncertainty that breeds risk. The likelihood of loss in trade is a risk. When it does happen however, it is not reckoned as risk, but as something that becomes certain. A fall in the market value of assets is a risk, but a decline in the value of an asset as a result of consumption (as a result of utilization or passage of time) is not a risk, because it is something that is certain to happen. Return on an investment is directly related to its riskiness. People are prepared to bear higher risks if these are accompanied by the probability of compensatory returns. The investor is concerned with measuring risk so that he does not bear a high risk in lieu of low returns. It is for this reason that people need measures of risk. Frank Knight in the early part of this century explained the difference between the meaning of risk and uncertainty in the economic sense. Risk is something in which the measuring of probabilities and the occurrence of undesirable events is possible, but uncertainty is a situation when measuring of probabilities is either not possible or is not beneficial.[7]

6. THE IMPORTANCE OF RISK ANALYSIS IN FINANCIAL DECISIONS

Risk analysis is the greatest common factor in financial decisions. After someone has determined his target, the first priority for him is to assess the forces that can possibly alter the course of events so as to prevent reaching the target. Financial decisions rely on expectations about what is likely to happen in future. Expectations are not realized unless events occur in the expected manner. Accordingly, the analysis of forces that can possibly lead to deviations from the expected course is exactly what is involved in the study of risk. The purpose is not elimination of risk for that is an impossible task. The purpose is to measure the risk involved so as to ensure that the person taking the decision receives compensation commensurate with the extent of risk he is bearing. The rule in requiring compensation suitable for the extent of risk is that people in general are risk-averse, i.e., they always prefer less risk to more risk.[8]

6.1 Risk Management is Not New to Human Life

Risks that people come across in their commercial activity are not new. Just as they recognize the importance of eliminating risk today and strive in different ways to deal with it, people in the past faced similar risks and tried to achieve the same objectives, as far as possible. Circumstances in the modern life are, however,

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[7] Knight (1921).

[8] Shapiro (1991), p. 101.

totally different. Modern life is less monotonous and moves at a faster pace as compared to life in the early days. In the past people were less mobile and the means of transport and communication were weaker. Further, they relied on a system of exchange based on barter. Despite all this, we find contracts practiced by earlier people that had risk management as the primary purpose. One such contract is *salam* (advance payment) that was practiced widely in agriculture. The people of Madinah used to practice this contract at the time of the Prophet (peace be upon him). He approved it. Sharī'ah has laid down its detailed rules as well as the conditions of its validity and vitiation. The contract of *salam* is intended to deal with the risk arising from fluctuating prices (price risk). The peasant is proficient in matters of cultivation, sowing, irrigation and harvesting, but is unable to deal with the market risk since he has no experience in trading. By selling his goods on the basis of description, and taken as a liability (usually his produce) he transfers this risk to those who have greater ability in dealing with market risk. Rules of *salam* stipulate that it is not permitted to specify goods being sold as the produce of a particular field. This step was taken when this contract became a means for transferring natural risks, like the risk of agricultural calamities and the absence of rain and so on, converting the *salam* contract into a type of gambling. The subject matter of the contract is goods sold by description, as a well-known liability on the seller. Thus, the contract of *salam* is specific to price risk.

7. THE FUNCTION OF FINANCIAL INTERMEDIATION

The basic function of banks, whether conventional or Islamic, is financial intermediation. By financial intermediation we mean the mediation by a banking establishment between the savers (group with a surplus) and those who employ the funds (group with a deficit). Conventional banks perform this function through borrowing from the first group and then lending to the second group. Islamic banks, on the other hand, perform this function by accepting capital on the basis of *mudarabah* from the savers and then employing these funds in ways that are in the nature of participation or trading. Some funds deposited with an Islamic bank are in current accounts. These are considered to be loans from the savers to the bank. The intermediary establishments undertake 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 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 financial intermediaries are in general short-term (current accounts, certificates of deposit and investment accounts) whereas their assets are of longer maturities. Banks get part of their incomes from borrowing on low interest rates due to short periods and lending with higher interest and

longer periods.[9]

c) **Conversion of a number of smaller assets into assets of huge proportions:** Financial intermediaries are a means through which the national economy is supported by making possible the conversion of small savings into huge capital sums, which can be used more effectively. 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 spreading of risk, but diversification is not possible for the owner of small savings because of the difficulty of distributing them among different investment opportunities. Financial intermediaries can realize this objective at low costs for small investors.

e) **Information generation:** Some economists believe that this is the most important function of financial intermediaries.[10] Due to asymmetric information between savers and employers of capital, assessment of credit-worthiness prior to lending, and acquisition of information after lending requires enormous costs, which individual savers cannot bear. Due to inability to assess credit worthiness of the borrowers at a reasonable cost, the savers always assume the minimum level of credit-worthiness and tend to refuse lending or ask for a higher rate of interest. Due to economies of scale and specialization, financial intermediaries can undertake gathering of information and its analysis, as well as monitoring at reasonable costs.

It may be asked why the role of the financial intermediary is not confined to the sale of information. The difficulty of verifying various types of information available with the bank, which cannot be done without accessing it, makes it difficult to convert this information into a service that can be accessed by the saver. Therefore, the work of the financial intermediary involves bearing the risk on its own. The saver bears the risk of the bank leaving investment decision-making to the bank due to its experience and record known to the saver. The commercial banks, therefore, borrow and then lend.

8. BANKING SUPERVISION

Banks differ from all other commercial establishments with respect to their susceptibility to instability that would affect their clients. For this reason, supervision by government institutions (like the central bank) is required so as to guarantee their proper conduct, adequate resources and stability. The causes of instability faced by financial intermediaries are:

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9 Fabozzi (1992), p. 145.
10 Megginson (1997), p. 415.

a) The function of financial intermediation results in banks' bearing debts that are many times their capital. These 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 are heavily affected by changes in economic environment.

b) The function of financial intermediation requires the bank to operate as a debtor and a creditor. It derives bulk of its profit from the difference in time periods and risks between the two sides of the relationship. A situation may develop that makes it difficult to maintain a balance between the assets and liabilities of the bank thus affecting liquidity. That can lead to instability.

c) Banks rely on the confidence that the people have in them. A bank cannot survive if this trust is shaken. This is something that makes a bank vulnerable to disturbances in the markets.

The principles and goals of banking supervision differ from one country to the other in accordance with prevailing conditions in each country and its financial and economic peculiarities. In general, the goals of banking supervision and control are:

- Ensuring that the bank is financially sound.
- Ensuring that the bank has good and adequate management structure.
- Ensuring that the bank protects the interests of its depositors.

The supervisory body adopts practical measures to ensure that these objectives are realized. It focuses 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 resources that will enable the bank to appropriately manage its risks (like the existence of sufficient capital, liquidity, and managerial skills).

From this it becomes quite clear that identifying the nature of risks underlying the Islamic modes of finance is extremely important. It leads to a superior form of control that helps ensuring stability of banking operations and effective control on the part of the central bank in order to protect the rights of those transacting with the bank.

9. CREDIT RISK AND ITS IMPORTANCE

The risks faced by banks in their operations are of many types: interest risk, exchange rate risk, trade risk (or market risk), political risks, and risks that represent changes in the value of tangible assets and goods, etc. Credit risk is deemed to be the most important type of risk faced by a bank in its relationship

with the owners of wealth. It is related to the ability of a 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 to a loss for the creditor and, therefore, becomes a risk for the bank. The existence of credit risk is not dependant on direct financing by the bank, like bank loans. The bank also faces this type of risk in guarantees and acceptance paper when the originator of the financial instruments owned by the bank is unable to meet his obligations (as in the case of bonds). So is the case in other indirect financing operations. Therefore, prudent bank management includes strict and detailed regulations specifically for credit risk with the purpose of managing it in a suitable manner.

Conventional banks face credit risk in almost all of their operations, because the relationship between the banks and those who transact with them is that of a debtor with a creditor in all cases. Islamic banks also face this form of risk in most of the modes of financing that they use. It is well known that *murabahah*, *istisna[*, and installment sale are sales with delayed payment thus generating debts in the accounts of the banks. The fundamental form of risk in all these contracts is credit risk. *Salam* gives rise to a commodity debt rather than a cash debt, but it also involves credit risk. *Mudarabah* and *musharakah*, on the other hand, are contracts of participation, and the funds given by the bank to entrepreneurs are not liabilities. Yet, these two also bear a credit risk in two ways. First, in the case of tort or negligence, the entrepreneur is liable to guarantee the capital which means a debt liability. Second, when the capital of *mudarabah* or *musharakah* are employed in a deferred sale, which is what takes place in most *mudarabas*, the owner of capital (*rabb al-mal*), the bank in this case, bears an indirect credit risk. This risk pertains to the ability of the counter parties to repay.

9.1 Significance of Studying Credit Risk in Islamic Finance

Those who deal with Islamic banks observe that the cost of financing on average is greater than the cost of financing by conventional banks. For example, compare the cases of two persons. One borrows 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. The other buys the car himself on the basis of *murabahah* with installments running over a period of three years. The second person will most likely, bear greater costs than the former.[11] This means that the excess amount

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[11] It is not proper for a Muslim to undertake a comparison between the *halāl* (permitted) and *harām* (prohibited) because a person who believes in God and the Day of Judgment has no option in this: "It is not befitting for a believer, man or woman, when a matter has been decided by Allah and His Messenger, to have any option about their decision" [Al-Qur'ān 33:36]. But what we have mentioned is for the purpose of studying the subject with which we are concerned. Although the loan carries a lower cost in the example given here, it bears interest, which is prohibited *ribā*.

charged due to delayed payment in *murabahah* is more than the interest on loan. Islamic banks do not deny this, but they respond by saying that their operations carry higher credit risks. When the relationship between the return and the credit risk is directly proportional, it is natural that the cost of Islamic financing be higher for bearing such risk. This is an issue that needs examination and consideration because 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 Islamic banks.

10. METHODS OF DEALING WITH CREDIT RISK IN CONVENTIONAL BANKS

Conventional banks have the structure and means for risk management and control that enable them to choose a suitable level of risk that the owners of the banks are willing to bear. Their operations are based on the rule that risk and time are like goods that are bought and sold. 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. He can dispose of those that he does not wish to hold on to and buy other risks that suit his aims and purposes. Conventional banks have developed ways and means for the management of credit risk. The following are by way of examples. It is not an exhaustive list.

a) 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. 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, and his ability to generate income in future, because the repayment of the debt depends on his cash receipts and payments.

b) Taking of collateral and personal and tangible securities along with an emphasis on the ability of the bank to redeem its claims from these. 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 beyond his control.

d) Banks lay down strict regulations and policies for follow up and recovery, directly or through agents, collectors and law firms. The contracts of loans usually contain conditions that grant the bank the right to collect installments by any legal 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, banks have developed instruments for converting debts into negotiable instruments that can be transacted or sold to third parties for cash. 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 selling assets with an undesirable risk and buying other assets in their place.

11. MEANING OF RISK FROM AN ISLAMIC PERSPECTIVE

The meaning of the word *khatar* in Arabic is honor and respect, and from this is the statement that so and so has *khatar*. *Khatar* also means rashness and supervision over ruin. It is the prize that is assigned for those participating in a wager. Al-Zamakhshari 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 we do not find the word used in the works of the earlier jurists in this meaning. This does not mean that the well-known risks, like the risk of fluctuating prices, credit risk, and the risk of loss faced by investments, were not prevalent in early financial and trade transactions. Risk exists in every contract that matures in future, and there is no doubt that this was known to them. It is for this reason that they permitted contracts of *sharikah* (partnership), *mudarabah*, *salam* and so on, as each of these contracts involves a transfer or sharing of risk. However, the economic circumstances prevailing in those days and the methodology adopted for contracts did not attach the significance to the idea that is given to it in modern financial transactions. Perhaps, the reason for this is that no methods for measuring risk were available to earlier jurists. It is well known that the significance of studying risk emerged only after the development of methods for measuring risk, and it was this that enabled the classification of contracts according to the degree of inherent risk and the inclusion of measures of risk in the process of decision-making.

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[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 (1992).

Although this meaning of *khaṭar* does not have a place in the works of earlier jurists, yet we often find researchers in Islamic banking arguing on the basis of *qawā*‘*id fiqhiyyah* (principles of jurisprudence) that a relationship of direct proportion between risk and return is well-known in Islamic law. Among these are principles emerging from the traditions of the Prophet (peace be upon him), "*al ghunmu bil ghurm"* (profit is linked to loss) or "*al-kharāj biḍ-ḍamān"* (Entitlement to revenue is based on corresponding liability for bearing loss). Along with these is the prohibition from the Prophet (peace be upon him) of earning profit without a liability and of transactions involving *gharar* (hazard). On the basis of all this, jurists maintained (for example) that the owner of capital is entitled to profit in a *muḍārabah* contract for he bears some risk, and that the lender in a loan contract is prevented from taking an excess or reward as he does not bear any risk. Further, the prohibition from the Prophet (peace be upon him) of 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 try to show that what is found in the works of jurists on this subject is different in meaning from what is claimed in these arguments.

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

As for the meaning of *khaṭar* (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. If they involve ambiguity or lack of clarity, they are deemed risk-bearing contracts without reference to the external circumstances surrounding the parties. These factors do not affect the meaning of *khaṭar* in *fiqh*.

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

- 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. It is *mukhaṭarah*.
- 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 *mukhaṭarah*. It is something that he chose himself and their contract of sale was not based on this.

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

12. *AL-KHARĀJ BIḌ-ḌAMĀN* AND "*RIBḤ MĀ LAM YAḌMAN*"

The word *ḍamān*, in the terminology of jurists, has several meaning. The Shāfi'ī, Mālikī and Hanbalī jurists employ the word *ḍamān* in the meaning of surety (*kafālah*) in the sense of fulfilling one's liability (*dhimmah*) by another. The Hanafīs use the term *ḍamān* in the meaning of obligation to compensate in financial terms for an injury caused to another. The majority of 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 *ḍamān* (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 thus the sale was not valid. The jurists rely in this on what is stated in the traditions: "*al-kharāj biḍ-ḍamān*" (entitlement to revenue is based on corresponding liability for bearing loss) and the tradition prohibiting "*ribḥ mā lam yaḍman"*(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 (peace be upon him) and he remained with him for some time according to the will of God. Thereafter, he returned him on the basis of a defect that he found. The Messenger of Allah (peace be upon him) judged in favor of his return on the basis of defect. The person against whom the decision was given said, "but he benefited from him." The Messenger of Allah (peace be upon him) replied:

al-kharaj bid-daman."

The jurists have disagreed about the chain of transmission of this 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-kharaj bid-daman* 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-Qabas 'alā Muwatta' ibn Anas*, "*al-kharaj bid-daman* is a tradition that is not sound."[16]

Those who uphold this principle argue 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 (peace be upon him), "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 (peace be upon him) 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 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 benefits of an usurped asset, Ibn Qudāmah says, "Those who do not impose compensation (by way of damages) argue on the basis of the words of the Prophet (peace be upon him), "*al-kharaj bid-daman*, and its liability is placed on the usurper."[17] On the basis of this reasoning, compensation is not awarded because he bears the liability during his possession.

Scholars disagreed about the jurisprudence of this tradition. Some of them considered it a fundamental principle in contracts. They, therefore, did not uphold the traditions that opposed this principle. Thus, we find that Abū Hanīfah did not accept the tradition of *musarrāt*[18] as it conflicted with one of his accepted

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

principles and it is a textual principle being a saying of the Prophet (peace be upon him): *al-kharaj bid-daman*. The reason for not accepting the tradition of *musarrāt* is that the buyer bears the liability of this goat in case it dies in his possession. The milk is the usufruct and it belongs to him in lieu of the liability. If he returns the goat to the buyer, he is not liable for anything.

The Hanafīs, likewise, did not accept the tradition about discount due to calamities (in case of sale of fruit on trees), because it goes against the fundamental principle in their view, that is, *al-kharaj bid-daman*. They also said a *mudarib* (worker) is not permitted to extend the money of *mudarabah* onward to someone else on a *mudarabah* contract, as this, in their view, is earning of profit without *daman*. Likewise is the contract of sub-letting by a tenant for he is earning a profit from something for which the liability is borne by the person who rented out the property initially. The Mālikīs adopted the other view despite the conflict with the principle of *al-kharaj bid-daman*,[19] because the tradition of *mussarrāt* is stronger in their view.

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

Ibn Taymiyyah has mentioned this issue in his Fatāwā (Rulings) saying, "The later jurists from the school of Ahmad, along with Abū Hanīfah and the Shāfi'īs, uphold the interdependence of the right to benefit from something and bearing the liability for it. 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 did not uphold loss due to calamities in the case of the sale of fruit on trees because once the buyer takes possession (and the transaction is valid) the burden of liability shifts to him. The second view in Ahmad's school, as mentioned by al-Khiraqī and others from among the earlier jurists, which is also supported by the principles of Ahmad's school, is that the right to benefit from something and liability for it 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 on the seller even though the buyer had the right to dispose it of through sale, or otherwise. He said, "not everything that comes

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much milk only to discover after a day or two that it was *musarrāt*. A Hadith says "Do not tie the udder of camels and goats. He who buys such an animal, has an option after he has milked it. If he likes he can keep it. If he dislikes it, he can return it along with a *sā*[of dates." This Hadith is related by al-Bukhārī and Muslim.

[19] *Al-Qabas*, vol. 3, p. 324.

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

within the liability of the buyer can be disposed of because in some cases 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 (this is a narration from Ahmad), even though the debt is not the liability of the creditor".[21] He then said, "The Prophet (peace be upon him) permitted the conversion of a debt denominated in one currency into another currency while the debt is liability of the buyer and has not been transferred to the liability of the seller. Likewise, in case of a debt arising from *salam*, it is permitted to sell it although its liability falls on the seller and has not as yet been transferred to the liability of the buyer." He said, "supporting evidence for this are usufruct in case of *ijarah* and sale of fruit before it is cut. It has been established by a authentic *sunnah*, which is not opposed by any other evidence, that the price may be lowered for the buyer when the fruit is affected by calamity. Despite this it is permitted for him to dispose it of. If it is destroyed, the liability would be upon the seller to the extent of the price he has charged just as the buyer is liable to the extent of the price he has paid." Thus, according to Ibn Taymiyyah, the linking of the right to benefit from something with liability is not a fixed principle. However, he did not permit disposal in a manner that would lead to profit without liability. Ibn Taymiyyah says, "Prophet (peace be upon him) permitted conversion of a debt at the rate prevailing on the day of the transaction so that profit without liability is not earned. This is how Ahmed reported the text with respect to the counter-value of *qard* and other debts stating that all these have to be converted at the rate prevailing at the time of the transaction.[22] The reason is that if permission was granted without this restriction, the transaction of exchange could take place at a rate other than the rate of that day which would lead to earning profit without liability. Thus, if the value of the debt owed to someone was a *dīnār* and the rate of currency exchange that day was 7 *dirhams* for a *dīnār*, but he makes the exchange for 8, 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 this goes against the principle, *al-kharaj bid-daman*. However, disposal is not prohibited in absolute terms because the realization of profit here is a mere probability.

It is possible to say *al-kharaj bid-daman* deals with a kind of risk that is inherent in all commutative contracts. This is the risk of destruction of the item prior to its possession by the buyer. The lawgiver, therefore, determines that the profit to be derived in such transactions be linked with liability (that is bearing the liability of loss). Thus, if a person buys goods by description, the contract is valid and permits the passage of property, but in order for the profit to be realized for a third party by means of sale, it is necessary that possession be taken to let this rule

[21] *Majmū' al-Fatāwā*, vol. 29, p. 398–401.
[22] Ibid, p. 510.

operate. The taking of possession leads to transfer of the risk arising from the destruction of property from the original seller to the buyer and entitles him to profit. This conclusion, however, is not always applicable due to two reasons:

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

Second: That the meanings of *al-kharaj bid-daman* and the prohibition of profit without liability have meanings different from the meaning of risk in financial transactions. Risk in financial transactions relates to taking decisions under uncertainty. Just as the parties to a contract face risks arising from the relationship created by the contract between them, there are many other risks that an individual faces. The principle *al-kharaj bid-daman* 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 direct relationship between profit and risk is an established proposition in all financial decisions. As for *al-kharaj bid-daman*, it is a legal text that determines the rights of the parties to specific financial dealings and is related to the liability arising from destruction that may afflict the goods that are the subject matter of a contract. Those who uphold this principle have linked the entitlement to profit with the bearing of this liability so that no injustice is caused to one party by the other party.

13. *GHARAR* SALE

The word *gharar* means hazard and deception. In *fiqh* terminology, it means something with concealed (uncertain) consequences.[23] It is something that may result in two outcomes, neither being more obvious.[24] *Gharar*, according to Ibn Rushd, refers to difficulty relating to existence or determining the value of something that will make it capable of delivery.[25]

The prohibition of the *gharar* sale is well established in the *sunnah*. It is related by Abū Hurayrah that the Messenger of Allah (peace be upon him) prohibited the *gharar* sale.[26] There is consensus on the prohibition of the *gharar* sale in the *Ummah*. Most contracts of sale, however, do contain some form of *gharar*. The

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

prohibition intended here, therefore, applies to substantial not trivial *gharar*.[27] The examples jurists 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 fetus, the camel on the loose and so on.

While there is some resemblance between the prohibition of *gharar*-bearing sales, and the meaning of risk in modern financial terminology, there are several differences between the two.

a) *Gharar* relates to a defect in the 'form' of a contract that gives rise to a risk, but risk by itself does not lead to vitiation of a contract. As for risk in its financial meaning, it is something that relates to circumstances surrounding the operations resulting from the contract, whereby the objective of the concerned party may not be achieved.

   For example, consider sale of goods against a deferred price. When these goods are present, are owned by the seller at the time of sale and the time and amount of payment is known and fixed, 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, consider a sale with deferred price that is linked to a financial index like LIBOR. When the time for payment comes the amount will be determined on the basis of this index. This contract bears a lower risk as compared to a contract in which the deferred price is fixed. However, tying the price to an index involves substantial *gharar* and it renders it void, even though the risk is lower. Therefore, we can say that the meaning of *gharar* different from risk in its financial sense, even though there are some similarities. *Gharar* pertains to contractual relationship and depends on the form of the contract. Risk, on the other hand, relates to outcomes arising from the contract.

b) *Gharar* has a fixed meaning. Therefore, if there is no *gharar* in a contract when it is concluded, *gharar* cannot arise later. In the example given before, if the debtor dies, we cannot say that the contract now contains *gharar* and it should be declared void after being validly concluded.[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.

14. 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 have other modes of financing like *mudarabah* and *musharakah*, in reality they focus on *murabahah* and *istisna‘*. 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 *mudarabah* and *musharakah* is yet in the early stages of development. Growth of these techniques will come out of indigenous efforts without any support from the experience of conventional banks.

Nevertheless, debts held by Islamic banking are different in nature from those of the conventional banks. This has important implications for credit risk. These include:

14.1 No Possibility of Increase in the Debt After it Has Been Established

Loans in conventional banks have repayment periods and the debtor is under an obligation to repay at specified periods. 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 increases in proportion to the extended period. The debt is called a performing debt if the interest is paid continuously. The banks rely on what is called rescheduling of debt in cases where the customer is unable to make payments on the appointed time but wants to maintain a good business 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.” There is no possibility 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 *murabahah*, *istisnā*‘ contract, *ijārah* or *iqtinā*‘, delays the payment, the bank cannot increase the amount by imposition of penalties for delay. Some Islamic banks that impose penalties for delay do so only as deterrence, and then donate the amounts so collected in charity. It is not permitted to the bank to benefit from this flow by registering it as a source of income. Islamic banks also adopt other measures to reduce the impact of this problem on their revenues. Some of these are:

i) Charging a higher rate of mark-up while selling on credit. Depending on the assumed pattern of payments by the customer, a higher price may be charged. It results in the deferred price imposing a 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 delayed payments. Two payment schedules are created. If the customer pays according to the first schedule (prompt payment), a part of the increased price is returned to him. The second schedule is based on delay and under this the entire price has to be paid.

14.1.1 Will the impossibility of increasing the amount of debt once it has been established raise the level of credit risk?

It is not possible to say that impossibility 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 depends 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. The purpose of the excess is deterrence. The imposition of penalties on the customer, which are later distributed by way of charity, is sufficient to bring the level of risk in *murabahah* to the same level as in loans given by conventional banks. The experience of different banks has shown that the credit risk in *murabahah* is not different from loans from this perspective.

14.2 The Effect of the Form of the Contract on the Level of Risk

The fundamental difference between Islamic and conventional banks is that the latter work 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 and debtor. 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. 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 their operations within the ambit of *murabahah* does not by necessity lead to reduction in the amount of banking risk, just as dealing in loans does not mean lower risk.

14.3 Prohibition of Trading in Debts

The sale of a debt before its maturity to someone other than the one from whom it is due, 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 amounts to dealing in *ribā*. More importantly, 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 a bank to restructure its assets in the portfolio. This without doubt leads to an ability to manage risk in a better way. However, this 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. This does not relate to credit risk. Rather it is related to liquidity risk.

14.4 Non-Permissibility of Conditional Discounting

Many customers may want to settle their debts before the maturity date. This is sometimes the best solution for them as well as for banks. When they do this, they rely on the stipulations in the loan contract that specify the amount of discount available if the customer were to do so. This type of provision allows the possibility of managing credit risk more appropriately. However, this method is prohibited in case of *murabahah* contract. Though there is nothing to prevent early settlement of debts and there is also nothing wrong in giving a discount for early payment, but stipulating this in the contract is not permitted. Some people think that this may occasionally cause some risk for the bank, but this is not true.

15. THE CAUSES OF HIGHER LEVEL OF RISK FOR ISLAMIC BANKS

As stated above, some instruments used by conventional banks for risk management are not permitted to Islamic banks. This means that the ability of Islamic banks of dealing with credit risk or 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 predominant use of *murabahah* as a form of financial intermediation. The contracts of *murabahah* have reached more than 90% of the operations of several banks. So much so that those that have been successful in employing other modes are found to focus on modes that also give rise to debts, like *istisna‘*. Considering the fact that the financial assets generated through *murabahah* are debts, possibilities of dealing with them within the permissible limits set by the Sharī‘ah are limited.

Murabahah made it possible for *al-‘āmir bil-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 *murabahah* with the burden arising from bank loans because each in the end is a debt. 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

murabahah deprived these banks of benefiting from possibilities afforded by the contract of *mudarabah* and the various types of contracts based on *musharakah* and *ijārah*. Perhaps, the most important cause of this is that Islamic banks operate in markets that have conventional banks also operating there and Islamic banks have to compete with them.

There is no doubt that *mudarabah* and *musharakah*, in all their types, bear higher moral hazard risks. The reason is that these modes in addition to risks relating to commercial activity also depend upon trustworthiness of the customers. 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 labor and production, and this is the source of risks that carry losses on investments. The other is the financial sector, which 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 prepared to bear. While clients of banks in the capitalist system strive to segregate the real sector from the financial sector, the Islamic banking model is based on 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 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*, *murabahah* 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 a financial intermediary to manage risk within the domain of the real sector?

In other words, is the financial intermediary that operates within the domain of permitted transactions, and its activity is restricted to the real sector, able to manage risk to an extent that will enable it to compete with conventional institutions? The source of all risk is the real sector because 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 owners of conventional banks do not deal with the risk

existing in the real sector. Rather they strive 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 it in lieu of a return. Is it then binding that all this takes place through prohibited contracts?

16. CONCLUSION AND FINDINGS

It is possible to say that Islamic banks in their present form, carrying huge debts as bank assets, face higher risks as compared to conventional banks. This is because they must use methods for dealing with credit risk within the confines of the sharī'ah. 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 *ahkam* (rules) of the sharī'ah pertaining to financial transactions. We cannot, however, conclude that the Islamic banking model by necessity imply 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 many types of partnerships and contracts of *ijārah* and *mudarabah*, affords possibilities of operating within the permitted ambit of the sharī'ah to adequately deal with the sources of risk.

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