Islamic Banking and Shock Absorbers

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1. Introduction

In recent years especially after the Global Financial Crisis (GFC), the need for "good" shock absorber tools has gained a great attention by bankers and policymakers. One tool has attracted an enormous popularity in recent years which is convertible contingent capital (or "CoCos") which is used to boost Tier 1 capital to meet the minimum required capital. According to the Financial Times, Coco issuance accounts for around 10% of all sub-ordinated bank debt issued in Europe in 2014 — the highest percentage on record — with S&P forecasting volumes to exceed US$1 trillion within 5 to 10 years. Is the context of Islamic banking, CoCos issuance is not an option. The reason for this is that Islam prohibits the receipt or payment of any pre-set fixed rate of return on money that is borrowed or lent. El-Gamal (2000) and Parashar (2010) explain that this prohibition is because riba (interest) drives poor people deeper into poverty while creating more wealth for lenders, who do not carry the risk associated with doing business or any activity. Islam considers transactions based on interest to be unjust, unfair and morally unjustifiable (El-Gamal, 2000).

2. Alternative to CoCos for Islamic banking to absorb shocks

As an alternative to interest, Islam allows trade: 'God has permitted trade and has forbidden interest' (Qur'an, 2:275). Trade contracts can take the form of investment contracts such as *musharaka* and *mudaraba***,** or debt-based contracts such as *murabaha* and *tawarruq*.

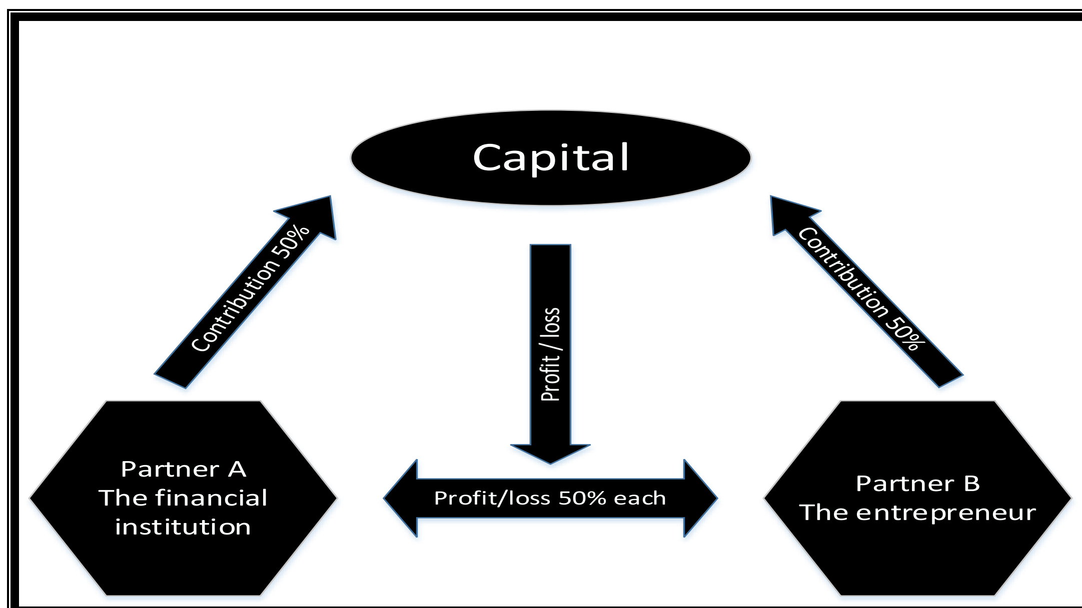
The first group of contracts, namely, investment instruments, allow the bank and the entrepreneur to bear the risk and share the profits (and losses) equally, which is termed 'profit–loss sharing' (PLS). Thus, trade is a partnership rather than the lender–borrower relationship

found in the traditional banking sector (Chapra, 2009). Mirakhor and Zaidi (2007) believe that this kind of contract would introduce a higher degree of discipline into the financial system because it would motivate financial institutions to gauge the risks more carefully and effectively monitor the use of funds by the entrepreneur. Incidentally and similarly, Greenspan (2010) argues that implementing an incentive structure of partnerships should be a goal in any future reform and suggests that banks should be required to issue some form of debt instruments that can be converted to equity when equity capital becomes impaired.

Profit and Loss Sharing (PLS) contracts

2.1 Musharaka (partnership)

Figure 1: Basic *musharaka* structure.

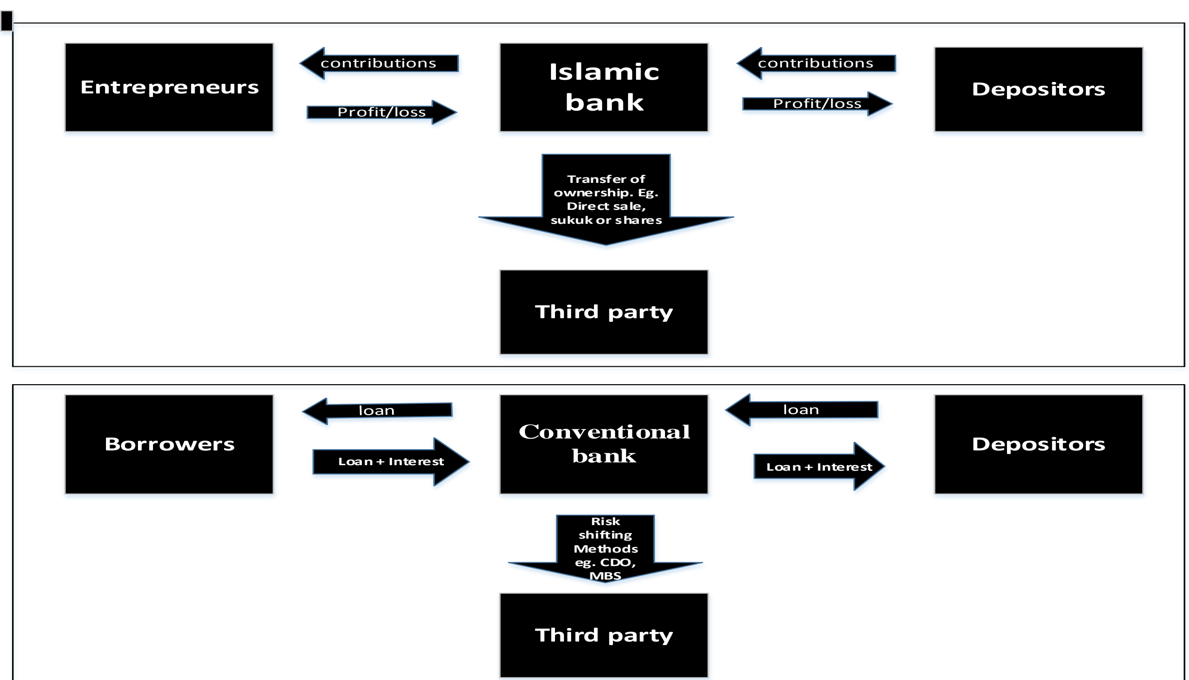


The *musharaka* contract in Islamic banking is the most obvious form of a participation contract or profit-and-loss-sharing model, which is simply a form of joint-venture contracts or pure equity (Abdul-Rahman, 2009; Johansen & Hanif, 2012).

During a period of economic downturn in which the losses are not solely caused by the entrepreneur's management, all the parties of the transaction, including the depositors, the bank and the entrepreneur, would share the losses according to their stake in the project (IFSB,

2013). This form of contract mitigates the distress faced by the bank and the losses to its shareholders, unlike with debt in conventional banks where the bank or a third party to which the contract has been shifted bears the entire losses. This type of contract can behave as a buffer to absorb shocks with depositors (partners) during crises, which has some similarity with contingent contracts in conventional banking. In addition to the sharing of profit and loss, *musharaka* as a genuine joint venture gives the Islamic banks the choice to sell their stake in a project at any time, which is not permissible in other debt-based contracts in Islamic banking (e.g. *murabaha*) (Abdul-Rahman, 1999). The exit choice can be conducted in several manners such as direct sale, issuing *sukuk* or through ordinary shares.

Figure 2: Basic difference between the *musharaka* structure and an ordinary bank loan.

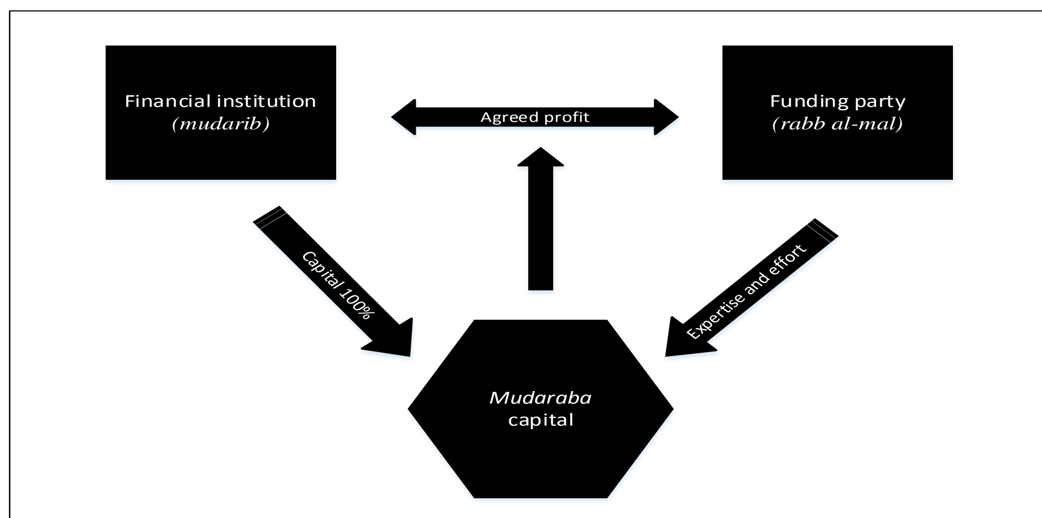


2.2 Mudaraba (money management)

Mudaraba is one of the investment contracts that Islamic banks offer to their clients. Under this contract, the financial institution acts as a money manager for its customers or as an agent for its customers to find other managers who meet the customers' objectives (Abdul-Rahman, 2009). In poor economic conditions, the financial institution or the entrepreneur who runs a

project, in the case of a two-tier *mudaraba* in which the financial institution enters into another *mudaraba* contract with an entrepreneur, the *mudarib* may lose part of or the entire *mudaraba* fund. In this event, the fund's owners lose their capital. Although the financial institution is not exposed to any direct financial losses, it is exposed to other forms of losses such as time, effort and probably the loss of reputation as a money manager (Abdul-Rahman, 2009, Johansen & Hanif, 2012; Kahf & Khan, 1992). In addition to these losses, there is another cost that the Islamic bank bears, which is the opportunity cost of forgoing a possible profit if it devotes its resources, personnel and time to other investments. Broadly, the manager (*mudarib*) would bear some or all of the financial losses if there were strong evidence that they mismanaged or breached the *mudaraba* agreement (Johansen & Hanif, 2012).

Figure 3: Basic structure of a *mudaraba* contract.



2.3 Sukuk (Islamic bonds)

Sukuk is defined by AAOIFI as 'certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity' (p. 307). *Sukuk* plays a significant role in the development of Islamic finance and is sometimes described as the 'Hollywood star of Islamic finance' (Wouters, 2010). There are a variety of risks involved with *sukuk*, for example, risks

associated with the modes of *sukuk*, asset structures and risk associated with the market. *Sukuk* faces all risk related to types of contracts such as *musharaka, mudaraba* or *ijara*. There are two principal asset structures in *sukuk*, the asset-backed and asset-based structures (Hanif & Johansen, 2012; Khnifer, 2010b) and a less common structure, the hybrid structure, which can be converted into equity in the originator's company or exchanged with the equity of a third party (Wouters, 2010). Asset-backed implies that the asset's title is transferred (true sale) to a special purpose vehicle (SPV) and the *sukuk* holders are only exposed to risks associated with the assets (McMillen, 2008). Consequently, the *sukuk* holders are isolated from risks associated with the originator, which makes it 'bankruptcy remote' (IFSB, 2013). Conversely, under the asset-based *sukuk*, the originator keeps the title of the underlying assets and not the *sukuk* holders, which implies that they would be directly exposed to the originator's financial distress, for example, the originator's bankruptcy risk, customers' credit risk, as well as its operational risk (McMillen, 2008). Another type of risk of *sukuk* is sharia-compliance risk because there has been a lack of consensus among Islamic-finance scholars on the permissibility of many types of *sukuk* (Usmani, 2007). Finally, the availability of a liquid secondary market remains a problematic issue in Islamic finance. The *sukuk* market was the most devastated segment of Islamic finance during the global financial crisis. According to Khnifer (2010a), in 2009 alone, there were 15 *sukuk* default cases, which placed individual investors, as well as institutional investors and those involved with them, in serious financial distress.

Why not PLS?

In practice, Islamic banks tend to rely heavily on debt-based modes, which dominate the assets of Islamic banks, rather than profit-and-loss sharing or investment contracts (Aggarwal & Yousef, 2000; Nethercott, 2012).

1. Most Islamic banks are based in countries with developing economies that suffer from a great degree of information imperfection. This leads to agency problems, as entrepreneurs may use the funds provided by banks for their own benefits, which makes banks biased towards debt-based contracts (Aggarwal & Yousef, 2000; Mirakhor & Zaidi, 2007; Sundararajan & Errico, 2002).
2. Khan and Mirakhor (1987), and Nethercott (2012) argue that adverse-selection can lead banks to focus on debt-based contracts, especially with less knowledgeable borrowers.
3. Another reason is that profit-and-loss-sharing contracts require the financial institution to invest more in managerial expertise to monitor the funded projects, which increases their expenses and consequently the cost of funds (Mirakhor & Zaidi, 2007).

2.4 CoCos sukuk

This is an ongoing debate among scholars and Islamic finance experts regarding the need for this type of contracts as well as ways to overcome the potential challenges

Khnifer (2014) summarise the main challenges as follows

- How to avoid Gharar and achieve equal treatment of original shareholders?
- Sukuk: Identifying the type of sukuk contract?
- Assets: Identifying the underlying assets?
- Recognizing from where the cash flow will come?
- The absence of guidelines on when to classify Islamic contingent convertible capital as part of the bank's capital.

2.5 Maintain thick capital and large reserves

In an attempt to manage the risk, Islamic banks have no choice but to maintain a relatively larger layers of equity capital compared to conventional banks (Ahmed, 2009). In addition to maintaining large equity, Islamic banks maintain a large portion of their assets in

reserve accounts with the reserve bank, which may negatively affect their probability as result of not making full use of assets they hold (Zainol & Kassim, 2012).

3. Summary and conclusion

The GFC proved the need for means to raise capital for banks in the event of financial distress with policymakers encouraging banks to innovate internal tools to absorb shocks rather than external tools such as bailout with tax payers' funds. In this paper, it has been discussed at the theoretical and practical levels, how Islamic banks absorb financial shocks, showing that PLS contracts can be considered as good shock absorbers and why they are not widely used in practice. This paper also shows how Islamic banks handle potential financial shocks by means of maintaining thick capital and large reserves. Finally, it shows the future trend and the potential challenges of developing sharia compliance CoCos.

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