Islamic finance is undergoing some sort of schizophrenia

In Person

Risk Sharing in the Age of Crises

By: Prof Dr Abbas Mirakhor

In her book, Payback, 2008, Margaret Atwood claimed: "In Heaven, there are no debts—all have been paid, one way or another—but in Hell there's nothing but debts, and a great deal of payment is exacted, though you can't ever get all paid up. You have to pay, and pay, and keep on paying. So Hell is like an infernal maxed-out credit card that multiplies the charges endlessly." Publication of this book coincided with the Crisis of 2007/2008. Since then, there has been a proliferation of books on the subject of debt, beginning with a book by Reinhart and Rogoff, This Time Is Different. In the book, the authors argued that—though labeled as banking or currency, or even balance of payment crises--all financial crises are at root debt crises. Massive accumulation of private speculative debt in the run up to the 2007/2008 crisis showed that "this time was no different". Aside from many books, well-researched theoretical and empirical papers published since then have established a nexus between credit, debt, leverage and onset of financial crisis.

Debt crises can be very painful. Consider Thailand; its GDP was hit to the tune of 40 percent during the Asian Crisis. Or, consider Indonesia: it took the country 25 years to reduce poverty by 50 percent and lost all that ground almost overnight as a result of the Asian Debt Crisis. A major point of research since 2009 is that debt crises, followed by massive economic downturns, are inherent in the regime of interest rate based debt finance (IBDF). There is a debate currently raging as to the direction of causality between economic growth and the growth of debt. There is, however, little doubt regarding strong relationship between them. At least, there seems to be little doubt that debt-fueled financialization (when and where finance grows much faster than the real economy) created the runaway indebtedness that, in turn, led to the Crisis. Private speculative debt morphed into public debt subsequent to the Crisis. As Tan Sri Andrew Sheng says: gains were privatized while costs were socialized as the taxpayers were forced to carry the costs of bailouts of financial institutions. In other words, the risks of financial contracts between and among financial institutions were shifted to the third parties, taxpayers, not involved in the transactions.

Risk shifting is one of the three methods of managing risk. The other two are risk transfer and risk sharing. The former transfers the risks of a transaction from one party to another. This happens, for example, when someone deposits funds in demand deposits in a bank. In turn, the bank transfers the risks to a borrower in form of a loan. It is important to note that in a creditor-debtor, IBDF-contract, the creditor does not transfer the property rights over the funds loaned to the borrower. Not only does the creditor maintain property rights over the funds loaned, the IBDF contract creates an instantaneous property rights for the creditor over the property of the debtor equivalent to the amount of interest payable on the loan.

As the name implies, in a contract of risk sharing, the parties share the risks according to their ability to bear them, as determined by their ability to take equity positions in the venture subject of the contract. A group of most prominent Muslim scholars, specialists in jurisprudence (Fiqh) asserted that risk sharing is the essence of Islamic finance (see, Kuala Lumpur Declaration, ISRA, 2012). In a recent book, Nicholas

The Quran notes three types of economic and financial transactions

"To forgo risk is to forgo freedom"

Naseem Taleb has argued that debt makes an economy fragile and advocates a regime in which participants in financial contracts have "skin-in-the-game." This is another term for risk sharing since the term indicates that everyone has a stake exposed to possible losses. Taleb argues that the regime he advocates makes the system antifragile in the sense that any shock to the system makes it stronger. Dr. Umar Rafi, one of the INCEIF's recent PhDs, has argued, in his Dissertation, that risk sharing Islamic finance (RSIF) system is antifragile.

The Qur'an notes three types of economic and financial transactions: trade (Al Tijarah: Verse 282 of Chapter 2), IBDF (Al Riba: 275:2) and all other transactions that do not fall in the first two categories, Exchange (Al Bay': 275:2). Arabs of those days understood the first two well. All aspects of trade and its financing was described for them in 282:2 covering transactions involving a well specified product to be traded on spot in the market. If either the payment or the specific product

were to be delayed, Qur'an called for contracts and witnesses. And IBDF was declared prohibited because it is risk transfer and the Qur'an considers an injustice. It appears that the injustice involved is symmetrical for the creditor and the debtor (in 279:2).

It is worth noting an important problem of IBDF: it misprices financial resources. It prices them far below their opportunity costs. The result is disequilibrium in the market (too much debt). Consider a depositor that receive two or three percent from bank on her/his funds at the bank. The opportunity cost of the fund is its best use: in the real sector with a rate of return averaging 14 percent. The injustice to the creditor is 12 percent, not considering inflation. The injustice to the debtor is obvious since all the risks of the fund borrowed are transferred to her/him. The amount and the interest have to be paid regardless of success or failure of the venture for which the funds were borrowed in the first place. Risk sharing requires that all parties involved share the risks of the venture according to their ability. In other words, all must have skin-in-the-game. Moreover, it will allow the market to price financial resources correctly.

If, as many analysts claim, IBDF has been responsible for all the past financial crises, then the storms are gathering once again. Since the last Crisis, the world has added another US$ 57 trillion to global debt totaling more that US$ 200 trillion or about 2.5 times the size of the global GDP. The difference is that this time the damage that the regime of IBDF can cause will be more severe. For one thing, during the last crisis, the emerging markets cushioned the global economy with their own dynamic growth. These economies are now in much less favorable position. Their own private and public debt has grown. Commodity prices have collapsed, capital inflows have declined, public sector revenues have decreased, and their currencies have declined in value leading to costlier servicing of dollar-denominated debt. With few exceptions, investment and growth have declined in emerging market economies, and their fiscal and balance of payments deficits have grown. Developing countries are also suffering from debt and debt-servicing burden. The question is how much longer the world would tolerate a regime that is the source of repeated instability and damage to human life, especially when more efficient and equitable alternatives are available.

In his book, Debt: The First 5000 Years, published in 2011, David Graeber observes that the Islamic prohibition on interest rate mechanism allowed markets to run on credit without indenturing debtors, countries and individuals, to the point that servicing debt becomes a major life experience, with many

"The spread of Islam allowed the market to become a global phenomenon"

spending their lives deeply in debt. He says: "The spread of Islam allowed the market to become a global phenomenon…a genuinely free market, not one created by the government and backed by its police and prisons—a world of handshake deals and paper promises backed only by the integrity of the signer—meant that it could never really become the world imagined by those who later adopted many of the same ideas and arguments: one of purely self-interested individuals vying for material advantage by any means at hand." RSIF has the ability to anchor the financial sector to ensure a close relationship between the real and the financial sector of the economy rather the present speculative-debt driven IBDF system with only tenuous connections to the real sector of the economy. The result would be a growing, stable, and antifragile economy.

Focus on Student

Elimination of Riba (Interest) In Financial Transactions

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INTRODUCTION

With financial turmoil of 2007 to 2009, the collapse of Wall Street on 28th October 1929 known as "Black Monday", economic disaster also known as "Great Depression" shook the capitalistic economy brutally and compelled many economists as well as societal intellectuals to find solution and reconcile carefully the soundness of the economic system. Consequently, the world experienced several severe economic disasters, which stimulated serious thinking on economic matters (ul Hassan, 2005).

With the failure of communism, capitalism had spread, many people think that capitalism in which interest plays a very important role, is the best economic system for the present world. These include banking, finance houses, business, industry and agriculture. Modern society think capitalistic economic system cannot exist without paying or charging of interest and no economy of the present world can survive with strict prohibition on the interest(ul Hassan, 2005).

Bergstra and Middelburg (2011), emphasized several different policies for dealing with interest. Interest can be defined as one of the forms of income from dividends, property, rent and profit. The price of rental for the use of money or as the percentage of excess of a money contracted for forward units of time over the spot or cash price of the sum thus contracted for forward delivery is referred interest. These include interest moderation is applied in all systems of conventional finance involving the imposition of higher bounds to rates of interest and to the size of loans, it essentially prevents people devastate their lives by accepting huge amount overdue. The upper bounds to interest rates are relative to the financial capabilities of the borrower, interest prevention which involves redesign of financial methods so that loans play a lesser role.

Debt prevention is the key means for achieving prevention of interest. The debts which are necessary can occur within the system and will still carry interest if the needs of parties cannot be satisfied in other technique and finally interest party comes on top of interest prevention. The party that deal interest must adhere to the interest prohibition policy and party who adheres to it will either pay or receive interest. Islamic finance has been designed in such a way that it implements both interest prevention and interest prohibition, and it does so to the extent that there is no need left for interest moderation.

Islam is a religion presenting a system for the welfare of the society and prohibits a system where people earn income without putting work or efforts. Islam encourages a business of

commodities and does not allow an exchange of precious goods with inferior goods of same goods with excess. This paper examines the meaning and types of riba, to explore verses of the Quran and their interpretations towards riba and to identify rational prohibition of riba.

DEFINITION OF RIBA

In particular, all forms of interest to denoting interest rates are termed interest and interest has become standard practice in the Western world (Bergstra & Middelburg, 2011). There is a consensus among Muslims that all forms of riba which lead to exploitation of the poor by means of usurious consumption loans, are prohibited by the Shariah and that banking should be in conformity with it (Nomani, 2003). The word "Interest" derived from the Medieval Latin word Interesse and became usura means an increase on principal. Interest means the way in which the intention of the lender to obtain more money in return from a loan than the principal amount. Both interest and usury are riba and have the meanings of "increase or excess" above the principle amount(ul Hassan, 2005).

Riba is an Arabic word, derived from the verb raba that literally means 'to grow' or 'expand' or 'increase' or 'inflate' or 'excess'. Technically, Riba refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or for an extension in its maturity. In terminology of fiqh, riba means an increase in one of two homogeneous equivalents being exchanged without this increase which is being accompanied by a return.

Riba is the payment or receipt of interest for the use of money

Aziz, Mahmud, and Karim (2008), defined riba as an excess over the loan given for specified period of time and the borrower will repay it with some excess amount. Riba which is equivalent to interest is defined as normal and exorbitant rates of interest compounded at short intervals. Riba means growth or increase over the principal amount of money. Riba is the payment or receipt of interest for the use of money. Charges against money lent or borrowed by financial intermediaries are called bank interest, is considered to be kin of riba(Iqbal, 2006). Interest is also an excess of money paid by the borrower to the lender over and above the amount of principal money for the use of the lender's money over a certain time period (Zamir). Riba is which is the amount taken or given in return for money or commodity in reply of postponing every type of debt. The increase in principal amount increases with respect to period for payment (Gül).

Classification Of Interest (Riba)

The riba is categorized into two main groups and the prohibition applies to all forms of it and can be named into:

Riba al-Nasi'ah

- Interest charged on loans and is constrained by a time limit
- Similar to interest which is a loan with a balloon of payment at maturity (Ahmad& Humayoun, 2011; Dahir, 2013)
- In this loan, the borrower pays the interest periodically and he pays interest and the original debt at maturity

Riba al-Fadl

- Means, to increase, add or exceed
- Also known as Riba al- buyu'
- Generally arises from the trading of fungible substances
- It applies to certain types of sales transactions of Ribawi goods both immediate exchanges as well as credit exchanges
- Ribawi goods are defined as commodities that can be a medium of exchange like gold and silver or non perishable staple food like wheat, barley, dates, salt and even rice

A fundamental concept of earning additional income or incremental value is based on exchange which comes out from a desire of an individual to acquire other specified commodity that belongs to another individual. The difference between the sale price and the purchase price is called profit or the difference between total revenue and total cost; these are referred profit.

Profit and riba share common features of mu 'awadah (mutual exchange). Each one comprises of goods for goods but one of them is just permissible and perfect while the other is unlawful

perverse and harmful that falls in the category of gravest sins. profit is a justified increase which is usually generated through exchange of two goods while, riba occurs either in the same thing or commodity to be returned with an increase(Nur, 2008).

There is a consensus of opinion among Muslim jurisprudence of all schools that riba al-nasi'ah as well as riba al-fadl are prohibited on the light of Quran and Sunnah respectively. The nature of the prohibition is strict, clear-cut and absolute. However, if the positive or negative return on principal depends on the final outcome of the business, it is allowed and it is in accordance with the principles of justice laid down in the Shariah (Chapra, 2006; Jammeh, 2010).

Prohibition Of Riba

Quranic Verses On Riba

There are 12 verses in the Quran dealing with Riba.

The Name of Surah	Surah Number	Verse Number	Total Verses
Suratul Rum	30	39	1
Suratul Nisa	4	161	1
Suratul Nisa	3	130–132	3
Suratul Al – Baqarah	2	275–281	7
Total			12

The word riba itself is cited eight times in the Quran, three times in 2:275 and one time in 2:276; 2:278; 3:130; 4:161 and 30:39(Siddiqi, 2005).

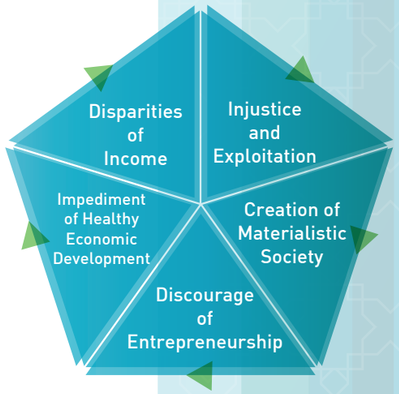
The injunctions of riba in the Holy Quran were revealed in a period spread over a number of years. Surah Al Baqarah Verses 275-81 were summarized as followings: first and foremost interest is firmly prohibited, secondly, interest is defined what is an excess over the amount of money borrowed, thirdly interest is unjust, it is destined to destruction and lastly it degrades and trims down persons who indulge in taking it. Riba generates various evils like moral evils, social evils and economic evils(Siddiqi, 2005).

Some Selected Ahadith On Prohibition Of Riba

1. From Jabir: The Prophet, may peace be on him, cursed the receiver and the payer of interest, the one who records the transaction and the two witnesses to the transaction and said: "They are all alike [in guilt]" (Muslim, Kitab al-Musaqat, Bab la'ana akil al-riba wa mu'kilahu; also in Tirmidhi and Musnad Ahmad).
2. From Anas ibn Malik: The Prophet, peace be on him, said: "When one of you grants a loan and the borrower offers him a dish, he should not accept it; and if the borrower offers a ride on an animal, he should not ride, unless the two of them have been previously accustomed to exchanging such favours mutually". (Sunan al-Bayhaqi, Kitab al-Buyu, Bab kullu qardin jarra manfa'atan fa huwa riban).
3. From Ubada ibn al-Samit: The Prophet, peace be on him, said: "Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt like for like, equal for equal, and hand-to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand" (Muslim, Kitab al- Musaqat, Bab al-sarf wa bay al-dhahab bi al-waraq naqdan; also in Tirmidhi).

THE RATIONALE PROHIBITION OF RIBA

Both Quran and Sunnah showed strong evidences for prohibition of riba. The researcher attempts to express some reasons for its prohibition to better appreciate the wisdom behind the injunctions. These are provided as the following:



Disparities of Income

- Lacking collateral and established economic standing, poorer segments of the economy are at an economic disadvantage when competing for credit to finance economic activities.
- As a result, wealth and income disparities increase among the society members, which generate envy and hatred among the society.

Injustice and Exploitation

- It guarantees lenders return without involvement in risk.
- It takes advantage of a man's inferior economic position, which kills the spirit of cooperation in the society and discourages people from doing mercy to each other.

Creation of Materialistic Society

- Riba nutures a materialistic society and people must work harder and harder and may execise unethical business practices in order to repair their bank debt.

Impediment of Healthy Economic Development

- Riba discourages innovation since potential entrepreneurs without security to pladge are denied credit (Alwosabi,n.d)

Discourage of Entrepreneurship

- Riba encourages the creation of wealth with no effort from its provider at the cost of borrower.

ELIMINATION OF INTEREST IN ISLAMIC FINANCIAL INSTITUTIONS

The Islamic financial institutions innovated and developed numerous financial instruments which are free from riba. The most frequently used instruments are: wadi'ah (safekeeping), mudharabah (profit sharing), murabahah (cost plus), ijarah (leasing), qardh al-hassan (benevolent loan) and musharakah (joint venture).

CONCLUSION

Islam is a religion that ensures complete success of human life in here and the hereafter. The Holy Quran and Sunnah clearly declared an interest comprising riba al-nasi'ah and riba riba alfadl as Haram and people are prohibited to practice it. Prohibition of interest in financial transactions is not unique to Islam but also other revealed books. The wisdom behind prohibition of riba includes unjust, destruction, creation of various evils like moral, economic and social evils.

Types of Concept	Description
Wadi'ah	Is a non-interest bearing demand deposit (checking account) similar to the current account offered by conventional commercial banks. It is also a non-interest bearing savings deposit account, but with a promise of giving hiba (gift) whenever the bank has "profits" to share.
Mudharabah	Account is a form of time deposit that cannot be withdrawn before the contractual time has elapsed. The bank as the intermediary (mudharib) gets profit on the basis of profit sharing-loss bearing principle.Murabaha (cost plus) is financing, facility in which Islamic bank buys the merchandise, adds an amount for "profit" and sells it to the buyer, to be paid back in equal installments or lump sum.
Ijarah	Is another way of enriching the Islamic bank at the cost of the borrower. The lessee cannot refinance or change the contract in view of changes in the market conditions. Any break in the contract goes in favor of the Islamic bank
Qardh al-hassan	Is given in good faith—the borrower is obliged to pay back the amount lent only, without any obligation to pay anything extra. It is quite obvious that not many loans would be given by a financial institution that is open for business of making money.
Musharakah	In which an Islamic bank and clients jointly finance a venture by issuing 'participation certificates' that can be bought and sold in the market. This type of joint venture is commonly known as sukuk, and the 'participation certificates' are traded like bond.