Banking Framework: The Case of The Islamic Banks
Prof. Suresh Gupta, Dr. K. R. Reddy

ABSTRACT
Risk and liquidity management are not only an important aspect in Islamic banking but a big issue in all banks whether Islamic or not. Risk management practices and processes are irrespective of religion, colour, or country. The Islamic banking has introduced innovations in the banking sector where transactions must pass through owning real physical assets. Islamic banks are growing rapidly and have developed their own techniques for management of these issues, which are elaborated in this paper. The following paper focuses on the use of profit-sharing modes, nature of risks faced by Islamic banks, and clarify the risks, and management of risk and liquidity.

Keywords: Profit loss sharing, Islamic banking, murabaha, mudarabah, musharaka.
Abbreviation: PLS, profit loss sharing.
INTRODUCTION

Islamic financial system is well developed and sophisticated with an important area of contemporary academic and policy interest with uninterrupted development that is reflected in countless publications of journals, books, research reports as a result of participation of world, individuals, universities, and research organizations and government. Several studies have been put forward to explain how Islamic banks perform. Islamic bank functioning is analyzed through Profit and Loss Sharing (PLS) principle and determine the effect of such system on mobilization of savings and allocation of small resources through banks, effectiveness of monetary policy, investments, and generation of real economic activity. There has been a vast literature that has been proposed stating Islamic banking and themes associated with it such as Islamic economics, finance, and monetary system. The Islamic banking system spreading rapidly, which is indicated through rapid growth of banks, its branches, accounts, and sum of money that bank handles. There has been growth in establishing an Islamic Capital and Inter-Bank Money Market, an Islamic Rating Agency and an Islamic Financial Services Supervisory Board, which means that Islamic financial industry has become significant for the international financial system. On account of this success, it is an opportunity for western style commercial banks to generate business by providing Islamic banking services to satisfy increasing demands of a growing Muslim population in Western countries and all over the world. Western glorious conventional financial institutions such as Citigroup, HSBC, JF Morgan, Barclays, Kleinwort Benson, Deutsche Bank, Lloyds, JP Morgan, Royal Bank of Scotland, Algemene Bank Nederland (ABN) AMRO, Goldman Sachs, American Express, ANZ, Grindlays, United Bank of Switzerland (UBS), Commerzbank, Société International Journal of Business and Management September, 2008 Général and BNP Paribas have started introducing interest-free products to their customers. Similarly, multinational corporations such as General Motors, IBM and Daewoo Corporation have begun to use interest-free services.

Risk has remained an important area of research for conventional finance as well as Islamic one, though several tools are developed by conventional finance for management of risk, Islamic institutions face a variety of types of risks related to Islamic modes of investments and finance. Risks encountered in Islamic banking are quite different in terms of nature and magnitude of risk. The following paper reviews Islamic banks operations in mobilizing and utilizing of funds and some explanation of Islamic modes of financing, the risk involved in Islamic banking with an emphasis on the liquidity risk and its challenges.

ISLAMIC BANKING FEATURES

The term “Islamic banking” refers to banking conducted on Islamic principles. Request and payment of interest is prohibited in the Islam banking but supported by principles of Islamic doctrine which are advocating risk sharing, discouragement of manipulative behaviour, and entrepreneurship promotion.

- A financial transaction should not lead to the exploitation of any party to the transaction, preservation of property rights, inviolability of contractual obligations, and transparency.

- Islamic finance is a form of financial innovation, where business and Islamic laws considerations are not mutually exclusive.

- To accept deposits from surplus persons on the liability side is basic mechanism of Islamic bank and then offering financing to deficit persons on assets side. Conventional banking operates on interest rate mechanism and profit/loss sharing for purposes of financial intermediation.
• In Islamic bank, there is no charging of interest but capital is rewarded with variable rate of return depending on the profit or loss resulting from the use of the funds during a given period.

According to the predetermined ratio, depositors also share in the profits of the bank, which results in partnership between the Islamic bank and its depositors and partnership between bank and its investment clients. This differs with conventional bank where there is mainly borrowing of funds paying interest on one side, lending funds, and charging interest on other funds.

PRINCIPLES UNDERLYING THE ISLAMIC BANKING SYSTEM

Islamic banking is based on Islamic teachings, which mainly involves prohibition on charging of interest; encourage earning of profits, no guarantee of fixed amount of returns, prefixed income or interest, nor return of principle deposit of money to people who invested within the bank.

THE FACTORS WHICH DISTINGUISH ISLAMIC BANKING FROM CONVENTIONAL BANKING ARE:

**Interest:**
Basic principle involves not charging any return for the use of money alone that is contracts and transactions must be free from interest. It is unjust to charge interest on loans as money is considered to be simply an intermediary between goods. There are differences between sale/trade and interest-based transactions. Capital involved in Islamic banking may grow or decline through time whereas in interest-based transactions, capital automatically increases over time. The most important belief in Islamic banking is that capital should not generate profit unless it is with human effort or any sort of risk is involved. It is considered that interest on loans is unfair since due to conditions of uncertainty, since no borrower can guarantee that profit will be enough to pay the interest due. It is unjust to guarantee return on capital or loan due to uncertainty when no human effort is involved.

**Value of the money:**
In accordance with Islamic consideration, money serves only as a medium of exchange and has no intrinsic value. According to Islamic considerations, money does not reproduce itself but grows when it is invested in tangible economic activity. Money also serves as a measuring tool, which defines value of a thing *Uncertainty or Gharar* which refers to acts and conditions involved in exchange contracts.

The concept of *ghrar* usually refers to concept of lack of knowledge and also implies deceit. Every business transactions which cause detriment in any form like hazard, peril leading to uncertainty in any business, deceit or fraud.

**Maisar Pure Games Of Chance**
A concept involving two parties in a combative game played for the sole purpose of winning at the expense of one’s opponent. The gain from such game is unlawful and also the act of playing it as it diverts one’s attention from productive occupation and virtuous conduct. Transactions undertaken for purely speculative process are not allowed in Islamic banking. Trading and investments which involve the risk of incurring losses are not allowed.

PROHIBITED ACTIVITIES OR COMMODITIES

Using or dealing in certain commodities is prohibited in Islamic law, products like pork, conventional Finance at interest, Tobacco, Gambling, Alcoholic liquor. In Islamic considerations, which recognizes capital as a factor but does not allow remuneration of capital by interest. This situation raises a question as to what will replace the interest rate? Therefore number of alternative financial instruments have been developed to provide various kinds of financial products
Islamic banking, deposits are treated as shares and depositors purchase equity position regardless of where the bank invests their capital.

USES OF FUNDS

A. Murabaha (mark-up):
Murabaha is a contract in which client makes deferred payments to Islamic bank for purchase of specified goods that cover costs and an agreed-upon profit margin. Each contract must involve two separate contracts; one, in which the Islamic bank procures goods from a supplier, and bank sells the goods to the client. As a result of which financing occurs through transfer of tangible asset and not through money. The only condition required is that bank should have ownership right of the commodity before selling it to the client. It can be a physical or constructive possession. Bank can incur losses due to non-payment of dues in stipulated time. To overcome this problem, banks can resort to mark down which is opposite to mark up to giving rebates as an incentive for early payments where ownership resides with the bank until all payments are made.

B. Mudarabah (Silent partnership):
Mudarabah is a contract between client, capital owner, and investment manager, and the Islamic bank that acts as a silent partner. In this type of partnership, Islamic bank provides the capital needed for finance the operation and expertise, management, and labour is provided by the client. A fixed rate of return is not guaranteed by Mudarabah contract return. The profit and loss sharing differs, where profit is shared between the bank and the client whereas loss does not result from negligence on the part of the entrepreneur but the bank has to bear all the losses and the entrepreneur’s loss lies in not getting any appreciation or compensation for his effort.

C. Musharaka (limited partnership):
Musharaka is an investment partnership where a joint venture is set up by the Islamic bank and another entity and there is participation of both parties at varying degrees in various aspects. The profit is shared between the partner and the bank to the pre-agreed proportions, which may differ from the proportion of capital contributed. Any losses will be incurred by both partner and bank. A musharaka contract is similar to a mudarabah contract, the difference being that in the former both the partners participate in the management and the provision of capital. In practice the Mudarabah and Musharaka contracts, the real problem is moral hazard and asymmetric information.

D. Ijara
Ijara is a leasing agreement where bank buys an equipment or productive asset for a customer and then leases it back over a specific period. The ownership of the asset is retained with the bank with all rights and the responsibilities. The reward of bearing risk is the profit earned on money.

RISKS SPECIFIC TO ISLAMIC BANKS

A. Commodities and inventory risk
This type of risk arises from holding items in inventory either for resale under a Murabaha contract, or to lease it under an Ijara contract.

B. Rate of return risk
Rate of return risk cannot be determined easily and differs from interest rate risk. A consequence of rate of return risk may be when the bank not being able to compete with other Islamic or conventional banks and the bank is subsequently under market pressure to pay the returns that exceeds the rate that has been earned on assets financed by Profit Loss Sharing deposit holders.
C. Legal and Islamic laws compliance risk
Coexistence of Islamic banks with other conventional banks results in a pressure to apply same regulation for both types of banks and a common legal framework is developed generally.

D. Equity position risk in the banking book
Risks inherent in the holding of equity instruments for investment purposes. A consequence of the equity position risk is the fiduciary risk that results from the management of investment accounts.

E. Withdrawal risk
Withdrawal risk arises in Islamic banks when depositors are paid share of profit not fixed \textit{ex ante}.

RISK MANAGEMENT

(1) Setting up a system for identifying measure, manage, and monitor various risk.
(2) A periodic risk report should be prepared like credit risk reports, operational risk reports, liquidity risk reports and market risk reports.
(3) An internal rating system IRS should be established Setting up an Internal Rating System (IRS) for Internal and external audit with management Risk information.
(4) Suitable disclosure about quality of capital, accounting standards, risk exposure to enhance transparency.
(5) Facilities and institutions should be provided to lender of last resort facility, deposit protection system, liquidity management system, and legal reforms.

LIQUIDITY MANAGEMENT

The Establishment of specialized institutions for managing liquidity risks has helped to solve the liquidity problems.

A. The Liquidity Management Centre LMC and the International Islamic Financial Market (IIFM).
B. Islamic investment certificates (Sukuk).

CONCLUSION

The paper focuses on various investment options in Islamic banking, prohibition of certain acts in Islamic banking, and set up to overcome risk and liquidity. The practices like Murabaha, mudarabah, and musharaka.

REFERENCES


