

appraisal systems than conventional institutions, and practices such as credit scoring to determine eligibility for financing are entirely legitimate under Shari'ah. Islamic banks are also quite justified in pursuing cases against unscrupulous debtors through the conventional course and under English law Shari'ah-compliant financial contracts will be enforced as long as all the parties have signed to indicate their consent.-Courtesy: Journal of Islamic Banking & Finance.

* (Professor Rodney Wilson is a Director of Post-graduate Studies of Duhrum University's School of Government and International Affairs. He is a consultant to the Islamic Financial Services Board.)

ملی مجلس شرعی کا قیام

اراکین مجلس ادارت مجلہ فقہ اسلامی

جناب ڈاکٹر محمد سرفراز نعیمی صاحب

جناب مفتی محمد خان قادری صاحب اور

جناب ڈاکٹر محمد امین صاحب کو

تمام مکاتیب فکر کے اہل علم و دانش پر مشتمل



ملی مجلس شرعی کے قیام پر مبارک باد پیش کرتے ہیں

عمدہ کھائی..... بہترین چھپائی

مسودہ دیجئے..... کتاب لیجئے

جمیل پبلشرز

ناظم آباد نمبر 2 کراچی

bank is also justified in levying additional charges to cover the costs associated with defaults.

There are, of course, a range of non-financial penalties that can be applied in the case of a payments default, notably the blacklisting of defaulters so that they will not have recourse to financing from any other bank, including conventional banks. In addition, it is possible to seek redress through the courts involving imprisonment or confiscation of passport, the latter being an especially effective deterrent in the Gulf. Payments safeguards can also be provided through the sequestration of assets, as murabaha and ijara involve financing real assets which can be seized if default occurs.

This is very much a last resort, as an asset seized may not be worth much to the financier where it is a particular piece of equipment or commercial facility that was tailored to the client's need and may therefore be unattractive to other purchasers. For second-hand equipment the resale value will inevitably be limited.

Shari'ah restrictions apply to the type of assets which can be used as collateral, as they should have usufruct and be halal. Conventional financial assets such as bonds or other securities that pay interest cannot be used as collateral, as an Islamic bank cannot hold such assets, and conventional accounts receivable are also problematic since the current value of these is usually discounted by the interest rate and firms that rely heavily on income from supplier credits function like riba-based banks.

In the case of personal Shari'ah-compliant financing of a vehicle or home purchase, the amount provided is usually based on salary, with a requirement being that the income of the client is paid directly into an account with the Islamic bank making the advance. In the event of a default, the bank can impose limits on personal access to salary until its claims are met.

CONCLUSION:

Under Shari'ah, those facing real problems in meeting financial obligations should be treated with leniency, but that does not imply that Islamic banks should be regarded as a 'soft touch', indeed, arguably, they need to be more rigorous in their credit

DEFAULT ISSUES AND PAYMENTS SAFEGUARDS:

Leniency towards debtors can be abused and it is often difficult to distinguish between those who cannot meet their obligations through no fault of their own and unscrupulous defaulters who will not pay. There are potential moral hazard problems in Islamic finance, and those who would take advantage of any perceived leniency by Islamic banks. Shari'ah-compliant contracts assume a degree of trust between the parties, who should be governed by a higher moral authority. Peer pressure can make borrowers acknowledge their responsibilities, as with micro finance, and if all those involved in Islamic finance feel they are part of a community with shared religious values this should help ensure compliance with contractual obligations.

For Islamic financing based on traditional principles of profit sharing, such as mudarabah and musharakah, there are also potential asymmetric information problems that increase risk. The difficulty with profit-sharing arrangements is that there is always the possibility of the management of the company receiving the mudarabah and musharakah financing overstating or being lax with control over costs, including its wage costs, which will result in a lower profit being reported and shared with the financial institution.

Rigorous auditing can alleviate the financial reporting problem, but not necessarily solve the conflict of interest over cost controls. With mudarahah the problem is compounded by only the financier, the rab-al-mal, bearing any losses, the argument being that the mudarib or entrepreneur has lost his or her time and should not be further penalised. Not surprisingly, this is a real deterrent to mudarabah and musharakah financing.

With murabaha, salam, istisna and ijara financing, there can be no additional financial charges levied in the event of late or non-payment since, if an Islamic bank benefited from such charges, this would represent an addition to the principal owed and therefore would amount to riba. However, the Shari'ah boards of most Islamic banks have approved a financial penalty being levied in the case of defaults, provided that the proceeds are given to a designated charity; a just solution especially in the case of unscrupulous defaulters where, arguably, immoral behaviour can be potentially cleansed through charity. An Islamic

One way forward might be to provide the client with a qard hasan loan, the only loan permissible under Shari'ah, as no interest is involved, although there can be an arrangement fee and a recurrent charge to cover the administrative costs. The aim of this loan would be to enable the client to meet their existing contractual obligations.

This would benefit the bank because no provision would then need to be made for non-performing debt. Qard hasan is of course unprofitable for Islamic banks, which like conventional banks are not charities, as they have to provide dividends for their shareholders and returns to their depositors. However, although such interest-free lending only constitutes a small proportion of Islamic financing, it can serve to reduce losses and the write-down in asset values once provisions are made for impairments.

The second sentence of Sura 2:280 in the Holy Quran concerns debt remission, which in modern financial parlance means debt forgiveness. This is obviously more costly for an Islamic bank than rescheduling, as is no longer the possibility of getting the principal returned or any further service payments on the bad debt. Assets will have to be written down and provisions made for their impairment so that overall asset quality can be maintained, otherwise the bank's own rating will be downgraded and the financial regulator will be concerned. Remission is therefore costly, but if the root cause of the failure of the client to meet their obligations reflects inadequate credit screening, or indeed negligence, by the bank, then it should share some of the responsibility for what has gone wrong rather than passing on all the blame to the client.

Furthermore, where clients get into additional unanticipated difficulties involving chronic health problems or terminal illness, then remission may be justified on grounds of humanity. Remission in these circumstances will bring goodwill from other clients and holders in the Islamic bank, with depositors prepared to accept a lower return and investors a lesser dividend in such cases as long as the reasons are properly explained.

TYPES OF CREDIT RISK AND SETTLEMENT OF FINANCIAL OBLIGATIONS:

The two major types of credit risk are, firstly, the inability to make regular payments to service debt and, secondly, the failure to repay the principal advanced. The latter may be repaid through regular instalments, at the end of the contract period, or subsequent to a service payments default that involves a breach of contract, necessitating the financing being recalled.

The obligations regarding repayment of principal will not be materially different in a Shariah-compliant contract, as it will usually be through deferred instalments in the case of murabaha, istisna or diminishing musharakah, and a lump sum final repayment in the case of an ijara wa iqtina hire purchase contract.

What is distinctive in Shari'ah-compliant contracts is that there should be no reference to *riba* or interest, but there will be reference to mark-up payments in the case of *mudarabah*, *salam* or *istisna*; sharing of profit in the case of *mudarabah* and *musharakah*; and rental obligations in the case of *ijara* - all of which should be honoured under the contract.

Although parties to financial contracts are liable to fulfil the terms and conditions they have signed for, exemptions can be made where the late settlement of obligations is due to genuine financial difficulties. The teaching of the Holy Quran is clear on this, and should be respected:

"If the debtor is in difficulty, grant him time till it is easy for him to repay. If ye remit by way of charity, that is best for you if ye only knew." Sura 2,280.

The first part of this injunction can be interpreted in the parlance of modern finance as justifying re-scheduling but keeping the same financing method and terms with no penalty to the borrower. The difficulty is of course to define what constitutes a 'genuine financial difficulty'. Where this is recognised, perhaps because of health problems, or unforeseen family circumstances, granting more time to honour financial obligations may be appropriate.

Credit risk management in Islamic finance (PROFESSOR RODNEY WILSON)*

The central issue addressed here is the implication of Shari'ah compliance for credit risk management. This concerns not only Islamic banks, Shari'ah-compliant investment companies and takaful operators, but also conventional banks offering Islamic financial products.

It also involves regulators since, if risks are not adequately identified and managed, resultant defaults could jeopardise institutional stability and lead to systemic failures in financial markets. Effective risk management is a core banking challenge, and any failure by Islamic banks could threaten not only their reputation, but also potentially that of the entire Shari'ah-compliant financial services sector.

The distinctive nature of Shari'ah-compliant financial liabilities and assets has implications for risk management. Investment mudarabah deposits cannot be guaranteed, which potentially conflicts with deposit protection insurance requirements. In murabaha financing operations and with ijara operating leases, Islamic banks take on ownership risks which conventional banks seek to avoid. More fundamentally, as Quranic teaching stresses leniency towards debtors, what are the implications for credit risk?

The discussion here is confined to credit risk, notably payments defaults. There are of course other types of risk not covered here - such as liquidity risk - which arise when there is a mismatch between the maturity of assets and liabilities. The latter arises with virtually all banking operations, and Islamic banking is no different in this respect.

Operational risk is also excluded although it can impact on credit risk as it involves inadequate management controls over employees and flawed internal reporting systems. Shari'ah risk has less impact on credit risk, as it arises from potential inadequacies in Shari'ah governance. It is best dealt with separately, as it links to legal risk, dispute settlement procedures and commercial arbitration, worthy topics for further research.