

Diversification of Islamic Banking Business and Products Driven by Shariah Contracts

The Islamic Financial Services Act 2013 provides the legal foundation for a comprehensive regulatory framework for the Islamic finance industry in Malaysia. An important focus under this framework is the development of Shariah and operational standards for key Shariah contracts. The standards outline the underlying Shariah principles and provide guidance on sound practices and effective governance for each contract. These standards are intended to promote transparency and consistency of Shariah contract application to enhance certainty and strengthen Shariah compliance by Islamic financial institutions, as well as to serve as a key reference to catalyse greater mutual respect of Shariah opinions across jurisdictions. Ultimately, these standards are envisioned to promote the offering of a broad range of Islamic finance products that can cater to more diverse customer needs and preferences.

In the last few decades, the focus of Islamic banks has been the provision of financing services to individuals and corporations, mostly for the purchase of assets and working capital (this business will be described as ‘financing’ in this article). Nevertheless, there is now increasing attention on other forms of Shariah contracts, including equity-based or risk-sharing contracts such as *musharakah* (partnership), and exchange-based contracts such as *ijarah* (lease) (these contracts will be described as ‘primary’ in this article). These primary Shariah contracts can distinguish Islamic products from the products of conventional banks and underpin additional funding options that can be offered by Islamic banks. This article explores the implications of Shariah contracts with a range of risk-return profiles for Islamic banks and their customers, and how a diversity of Shariah contracts can enhance growth opportunities for Islamic banking business.

Risk-Return Profiles of Various Shariah Contracts

The relationship between risk and return in Islamic finance is captured in the Islamic legal maxim of ‘*Al ghum bil ghum*’, which in essence refers to the concept of ‘no risk, no return’. This legal maxim requires a contracting party to undertake risk and bear responsibilities as a precondition for entitlement to profits. This requires both Islamic banks and customers to assume certain responsibilities which may include mutual risk-taking. Profits earned by Islamic banks and the pricing of banking services must correspondingly reflect the responsibilities and the level of risk borne by each party.

Guided by this principle, Islamic finance provides a diverse spectrum of Shariah contracts with different risk and return profiles under two models, namely the primary and financing models. The primary model is operationalised through a single Shariah contract where contracting parties share the same types of risks (under risk-sharing contracts), or where Islamic banks assume specific risks (under exchange-based contracts). Under the primary model, Islamic banks would be exposed to a wider range of risks such as business risk and risks associated with the holding and management of physical underlying assets, in addition to financial risks.

On the other hand, the financing model is applied through a combination of certain primary Shariah contracts with other ancillary contracts, such as *wa’d* (promise) and *wakalah* (agent). These ancillary contracts enable Islamic banks to mitigate specific risks and achieve the principal objectives of a particular transaction. As an example, where the objective is for an Islamic bank to provide financing to a customer by purchasing an asset on behalf of the customer, *wa’d* is used to effect the eventual transfer of the asset to the customer since the bank does not have the intention to own the asset purchased. Hence, consistent with the principal objective of providing financing under this model, the ultimate risk and return profiles are similar to that of conventional financing.

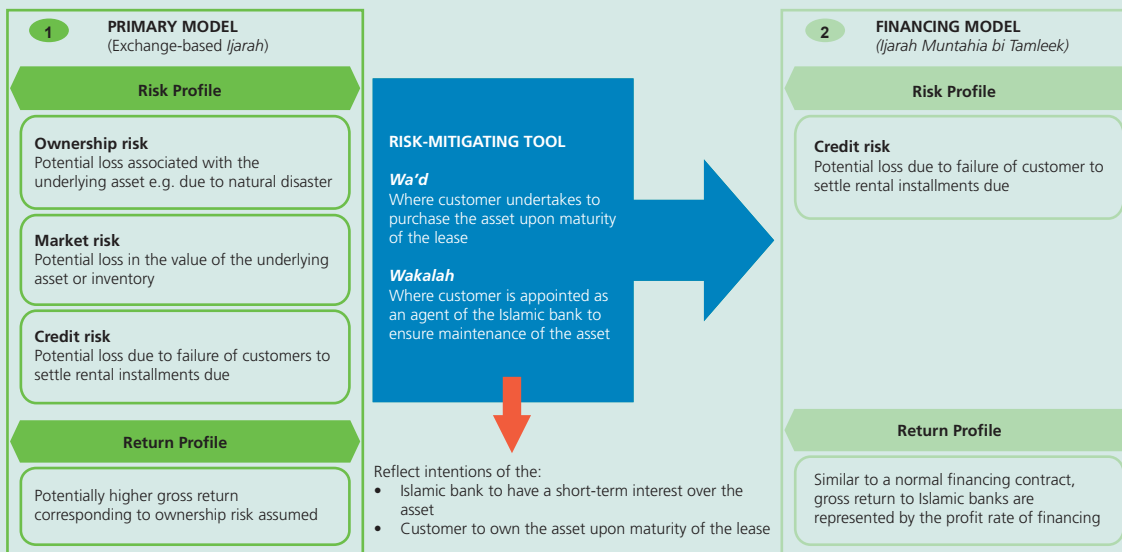
These models will give rise to different risk and return profiles corresponding to the degree of responsibilities and the level of risk borne by Islamic banks and customers. Diagram 1 provides an example of how risk and return profiles vary for different Shariah contracts under primary and financing models.

Diagram 1

Samples of Different Risk-return Profiles of Two Shariah Contracts (*Ijarah* and *Musharakah*) under Primary and Financing Models (from a Bank's Perspective)

Contract application

Ijarah contract is a lease contract that transfers ownership of usufruct of asset in exchange for rental payment. The ownership of the asset remains with the Islamic bank as lessor throughout the lease period.

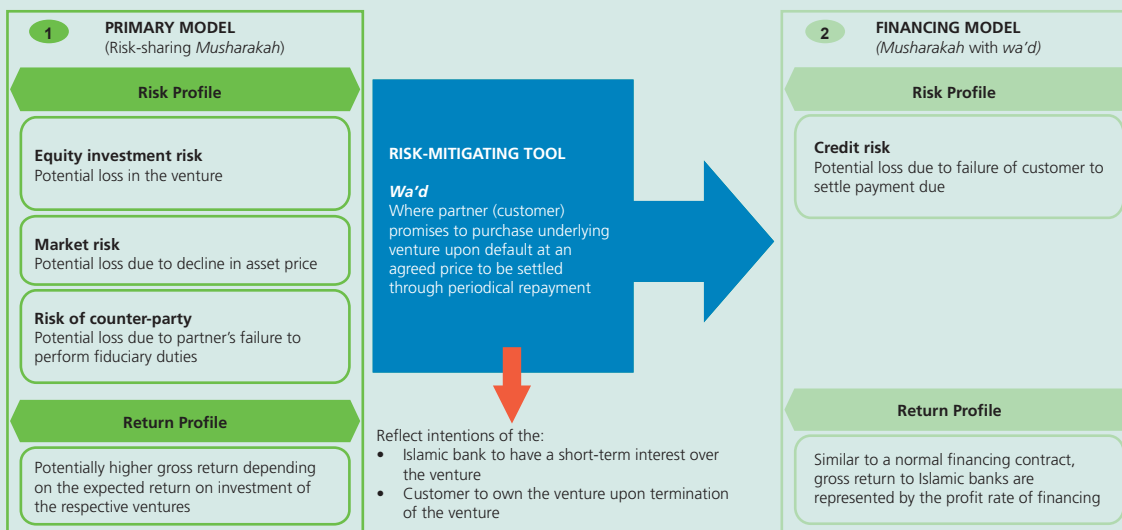


Alteration in risk profile

- Primary : Ownership risk entails Islamic banks to bear maintenance costs related to ownership of asset such as quit rent for house
- Financing : Transfer of asset ownership upon maturity of lease through *wa'd* create commitment from customer to purchase the asset, hence, enabling Islamic banks to eventually shift ownership risk to customer via *wakalah*

Contract application

Musharakah is primarily used to set up a business venture between partners who contribute capital and share profits of a business venture according to predetermined profit-sharing ratio. Upon default or termination of the venture, both partners will exit via a dissolution of the venture or selling of the venture to a third-party at a mutually agreed price.



Alteration in risk profile

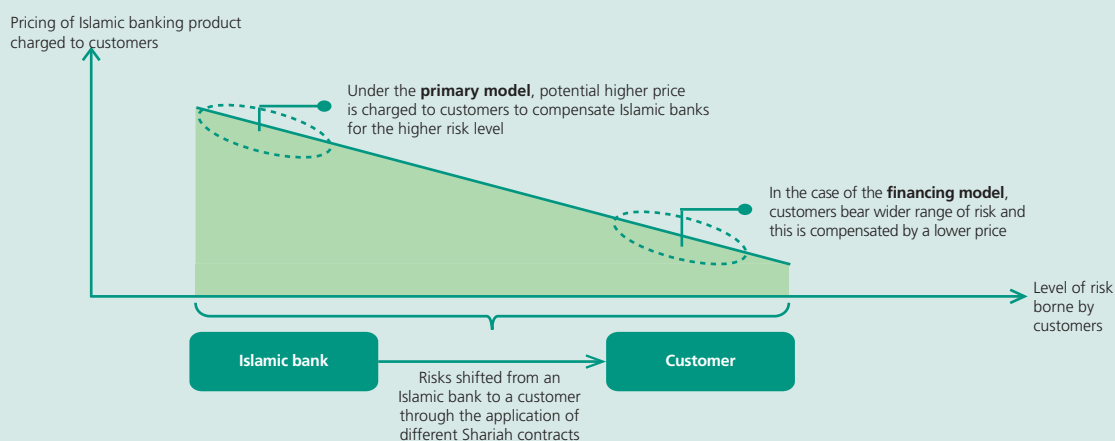
- Primary : Islamic banks and customers share the risk of a venture, hence bearing risks associated with equity investments
- Financing : A promise by the customer to eventually purchase the asset would ultimately expose Islamic banks mainly to credit risk

Impact on Pricing to Customers

Different levels of risks and obligations borne by Islamic banks and customers under various Shariah contract applications would translate into different pricing levels, as shown in Diagram 2.

Diagram 2

Illustration of the Inverse Relationship between the Level of Risks Borne by Customers to the Pricing of Islamic Banking Products



Under the financing model, Islamic banks assume mainly credit risks, with customers bearing greater responsibility of wider range of risks such as those arising from dealing directly with suppliers or defects in the acquired asset. The profit margin earned by the Islamic bank will be commensurately lower, while customers benefit from the lower pricing for the financing obtained. Conversely, under the primary model, the pricing of Islamic banking products will be relatively higher commensurate with the responsibility and level of risk assumed by the Islamic bank.

The different attributes of the financing and primary models thus provide a broader range of product options for customers with differentiated pricing to meet their specific preferences and needs. Diagram 3 illustrates an example of a product offered under *murabahah* contract.

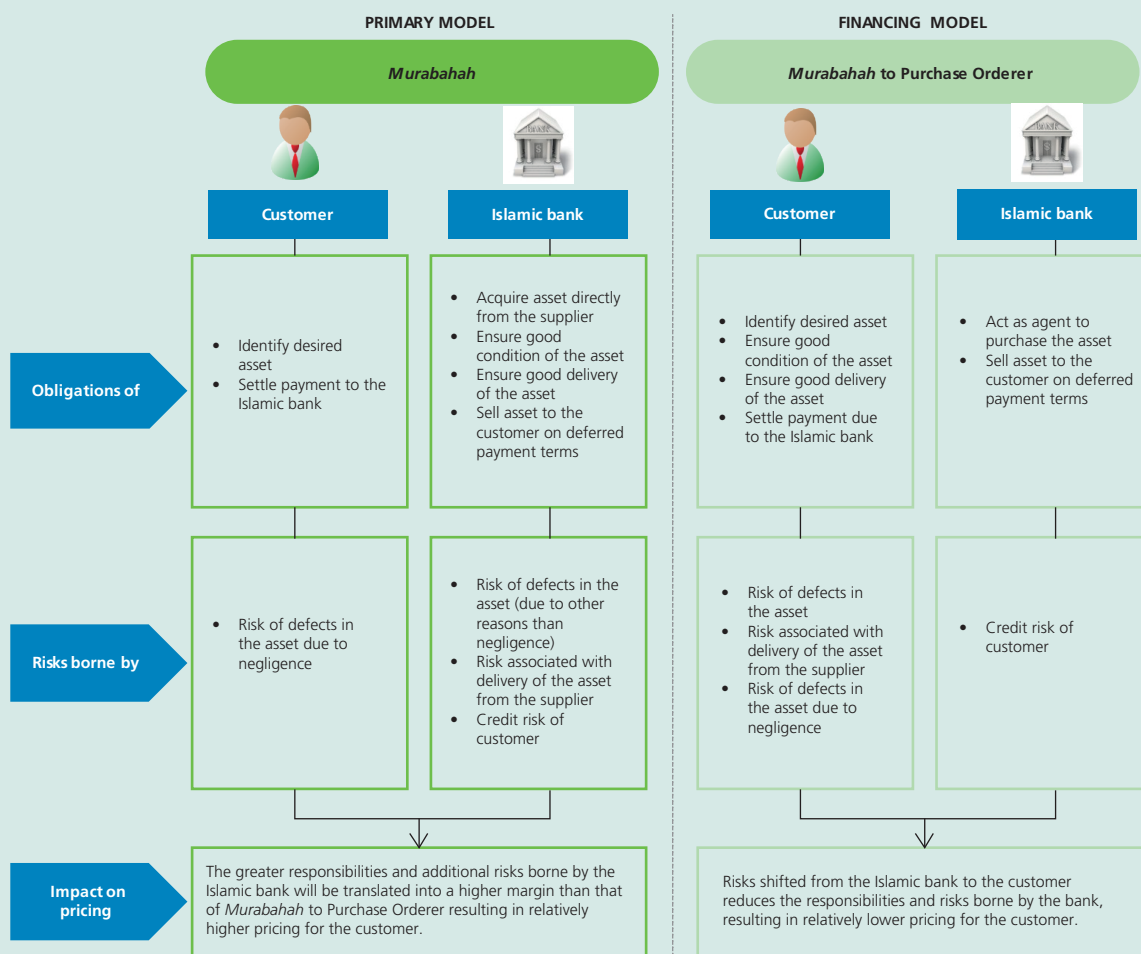
Regulatory Expectations on Islamic Banking Operations

The risks and obligations borne by Islamic banks under various Shariah contracts will require significant modifications on the design of existing infrastructures in Islamic banks. These risks and obligations also have direct implications on the appropriate governance arrangements, business conduct, strategies and risk management to ensure that Islamic banks perform their fiduciary duties effectively and efficiently.

Diagram 4 depicts the differentiated regulatory expectations for the operations of Islamic banks when offering products under the financing and primary models. These regulatory expectations form an integral part of the Shariah and operational standards of key Shariah contracts that are currently in various stages of development by the Bank. To date, the Bank has issued final Shariah and operational standards for *murabahah* in April 2013, while concept papers on 11 other Shariah standards and two operational standards have been published for industry feedback.

Products under the primary model require additional governance and risk management measures that are appropriate for the risks inherent in the contracts, in addition to existing arrangements for managing financial risks. Regulatory capital requirements should also reflect the types and level of risks involved to ensure that risk exposures of an Islamic bank are backed by an adequate amount of high quality capital. This is to ensure that risks and infrastructure required are adequately considered in the business strategies of Islamic banks that offer such products.

Diagram 3

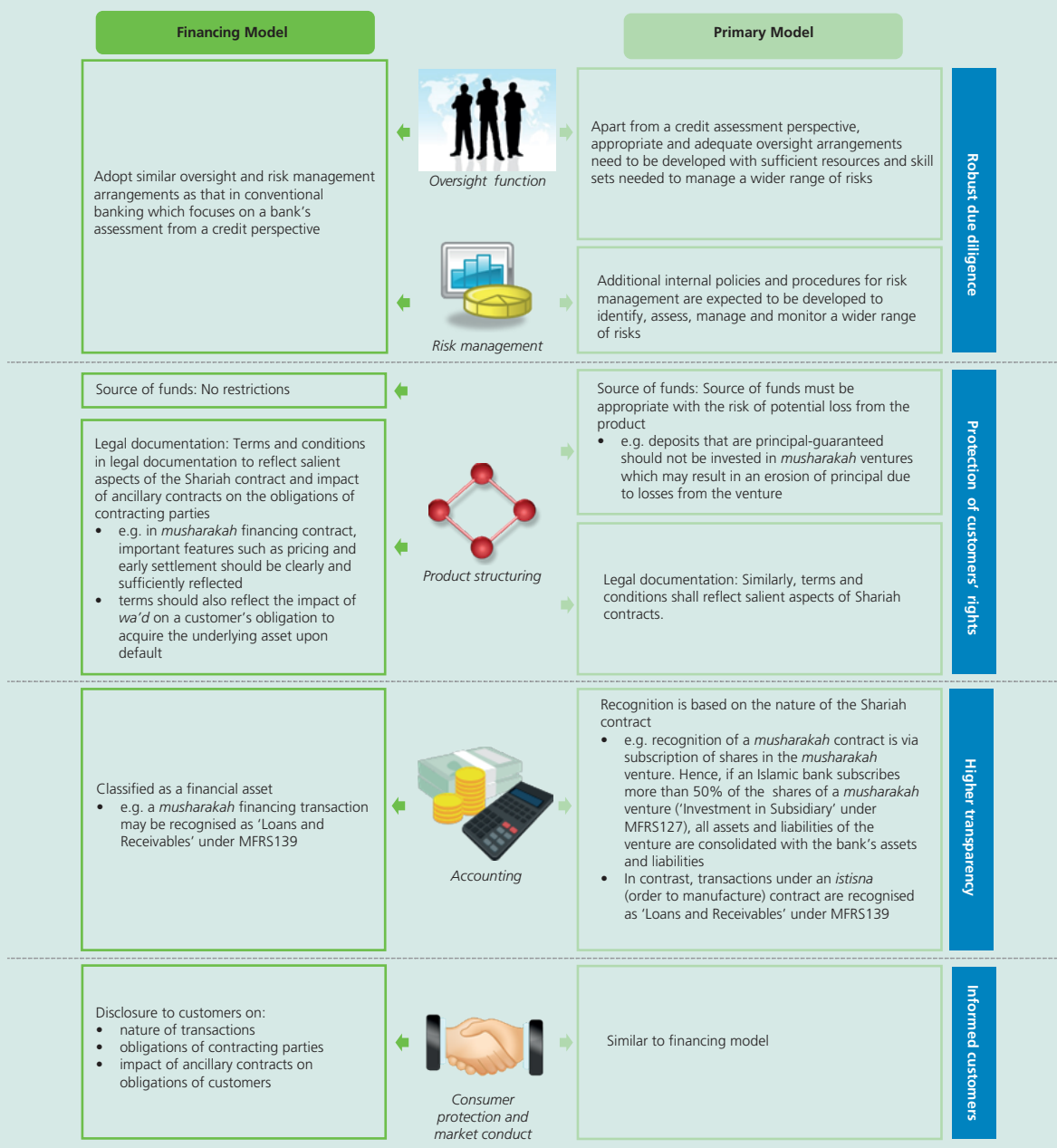
An Example of a Product Offered under *Murabahah* Contract

The terms and conditions of each product have to clearly reflect the salient aspects of the contracts, in order for customers to be fully informed of their rights and obligations. Market conduct requirements, including disclosures, also vary based on the nature of products offered to ensure a high level of transparency that commensurate with the risks borne by customers. Products must be structured to ensure that funds placed by customers are properly channelled in accordance to the agreed terms and conditions. These policies and infrastructure are important to ensure the interests of customers and other stakeholders are protected, which in turn will promote confidence and trust in Islamic banks.

Islamic banks should also conduct suitability assessments to ensure that products recommended, from among the different types of Shariah contracts available, are the ones that best serve the needs and preferences of customers. The active participation of customers in seeking a clearer understanding of Islamic products, especially how these products may differ from that of conventional banks, is also important to ensure that the expectations of customers are met by the benefits acquired and obligations assumed under an Islamic financial transaction. Significant efforts are needed to educate and promote greater awareness among customers on the different options available under both financing and primary models. Among initiatives by the Bank to promote more informed customers include the issuance of Guidelines on Product Transparency and Disclosure that outlines disclosure principles and requirements that must be observed by banks.

Diagram 4

Differentiated Regulatory Expectations on the Operations of Islamic Banks under Various Shariah Contracts



Conclusion

There are significant opportunities for the product offerings of Islamic banks, currently largely concentrated on the financing model, to expand into products based on the primary model. The potential for this new business area is growing given the demand for such products, particularly among small and medium enterprises. The evolution of a comprehensive mix of products based on primary and financing models is a major move which will significantly alter the current banking business model of Islamic banks. Hence, Islamic banks should ensure that the necessary infrastructures are developed to accommodate this change. Ultimately, this will place Islamic banks in an advantageous position to cater to a wider range of customers, in turn creating a competitive edge for Islamic banks while providing the conditions for the sustainable and expanded growth of the Islamic finance industry going forward.