



**Harvard-LSE Workshop:
London School of Economics - February 26, 2009**

**Workshop on Risk Management:
Islamic Economic and Islamic Ethico-Legal Perspectives
on the Current Financial Crisis**

A short Report

Prepared by
Husam El-Khatib

Introduction by Zohaib Patel

THE WORKSHOP

Continuing with the successful model of earlier workshops in 2007 and 2008 – on the topics of *tawarruq* and *sukuk*, respectively - the Harvard Islamic Finance Project (IFP), formed under the auspices of the Islamic Legal Studies Program at Harvard Law School, jointly hosted with the London School of Economics (LSE) a workshop on risk management in Islamic finance on February 26, 2009.

IFP engaged an influential group of academicians, economists, industry practitioners and Islamic legal scholars, to discuss the features and tools of risk management in Islamic finance and to understand how the current economic and financial crisis might reshape future development.

This report is a summary of the key issues and concepts discussed during the workshop and points raised by participants in their pre-workshop comments.

THE AGENDA

1. The Current Financial and Economic Crisis within the Conventional Markets: An Overview
 - What are the primary factors behind the crisis?
 - What lessons can be learned from the crisis?
 - How will risk management change as a result of the crisis?
2. Definitions and Principles of Risk Management in Islamic Finance
 - What does risk management attempt to achieve within the Islamic financial framework and how does this differ from its conventional counterparts?
 - What do classical legal norms and rulings tell us about the general principles that should govern the objectives and practices of risk management in Islamic finance?
 - Is the distinction between risk-sharing and risk-shifting useful and important?
 - How to balance the equation: “Risk management for one is speculation for the other.” Clarifying the boundaries of speculation.
3. Features and Tools of Risk Management in Islamic Finance:
 - Case studies of hedging mechanisms used for risk management in Islamic finance: Profit Rate Swaps, Currency Rate Hedges, Total Return Swaps, and Options (*Arboon*).
 - Do these current products conform to the principles and objectives of risk management in Islamic finance as discussed above?
 - What is the economic impact of these products?
4. The Future of Risk Management in Islamic Finance
 - How may the current financial crisis reshape the concept of risk management in Islamic finance?
 - What new transactional tools or mechanisms should be developed?
 - What institutional or regulatory arrangements would be desirable?
 - What trends and issues are we likely to see in the next five to ten years?

INTRODUCTION

The workshop was attended by a group of influential Islamic legal scholars, academicians, economists, bankers and industry practitioners, who were welcomed by the Directors of IFP and LSE, Dr. Nazim Ali and Sir Howard Davies, respectively.

The financial crisis, which was the backdrop of the discussions, and the need to revisit risk management practices were underscored in the opening addresses. The crisis, at its core, demonstrates the dangers of “group think” and over-optimism in clouding corporate decision-making and risk reigning. Before the crisis, it was viewed as risky not to be seen participating in this market. There was an assumption that house prices would increase indefinitely and the credit risks were all mitigated. In this regard, risk managers and board members of risk committees would have better served institutions as contrarians in their assessment approach.

Understanding risk is key to managing risk. However, undermining this key tenet was the over-complexity of many financial instruments, which even managers failed to understand. The resulting underassessment fed into misaligned models concerning the true risk interactions of various securities within portfolios, causing misleading accounting and enterprise risk measures and hedges. It also highlighted the importance of looking at gross numbers and not just net figures.

The Islamic finance industry is an important part of the global financial fabric. As such, it too is not immune from many of the challenges faced by the global financial industry. This risk management topic takes on a greater level of importance as everyone tries to review and to reflect on the lessons learned from this crisis.

WORKSHOP OPENING

Professor Frank E. Vogel, moderating the workshop, introduced the structure for the discussions and the overarching issues concerning risk management and the financial crisis that burden even the Islamic financial industry today. The workshop participants were directed to touch upon the permissibility and advisability of certain Islamic concepts and principles as applied to modern finance and risk management practices.

LESSONS FROM THE FINANCIAL CRISIS

Conventional Thoughts on the Financial Crisis

Professor Willem Buiter, Professor of Political Economy at the LSE, set the context of the workshop discussion by presenting an introduction to the financial crisis and highlighting its regulatory shortcomings from the perspective of a senior conventional economist.

The scale and the vehemence of the problems faced by the financial community, without a doubt, reflect a real crisis of the financial system itself. The near collapse of the global financial architecture reveals the true extent of the excesses going on at the time and the near absence of the global regulators.

The previous trend toward liberalization and the “light touch” regulation of the financial markets have now quickly reversed into a sudden case of regulatory capture in an effort to warrant closer scrutiny of the financial system. National regulators intentionally had softened regulations as a way to attract business to their nation. Furthermore, regulations had remained at the national level, failing to aggregate the actions of individual institutions and global instruments. The overall effect of which, led to staggering levels of dishonesty, partial truths and a general lack of ethics in business.

Most affected by the crisis are the global ‘border-crossing’ financial institutions. In the current stressful financial and political climate, nationalistic priorities quickly dominate and prevail. Thus, central banks were quick to save only their own national institutions. Overly generous government subsidies in the form of state aid were provided to those entities at the expense of a distortion in competition, leaving other global financial institutions to fend for themselves.

The financial crisis could also be considered a crisis of the current ‘Anglo-Saxon’ model of finance. On the one hand, there is the relationship banking arm— or the ‘originator-hold’ model – which is good for developing and building trust. However, it is inherently based on an ‘insider protection’ model. On the other hand, you have the investment banking arm - or the ‘originator-distribute’ model – which deals with liquid and tradable securities. The current crisis has now flipped the two models, so what was liquid became illiquid, and vice versa. It also created a mismatch between liabilities and liquidity.

Substantial misunderstanding and mismanagement of risks, at the institutional and organizational levels as well as at the instrument level, is another cause. The trading of risk became easily falsified and the transfer of risk was made to parties willing to, rather than able to, bear risk. For example, AIG, as an insurer was already highly risky and yet, the investment bank component of the insurance company was not regulated, as it was part of the overarching holding company. Yet, AIG took on more risk than it could feasibly bear.

Factors that everyone thought would help regulate the market actually helped destabilize the markets, such as Basel 2 and an over-reliance on financial models. With such financial models, risk management boiled down to risk quantification. This then led to the illusion of ‘precision’ - as if the risk quantified is accurate and flawless – providing a false sense of security among senior managers and watchdogs. From now on, financial regulators should have to micro-manage all financial matters, for example, consider imposing leverage ceilings.

Complex instruments, like credit default swaps and other derivatives, incorrectly attempted to achieve minimal risks for attractive returns. Moreover, their documentation was not easy to understand.

The crisis highlighted the systemic problem of institutions ‘too big to fail’. Stronger competition regulation is required in order to limit their future size. Anti-trust regulations need to be enforced along with conflicts of interest rules. If institutions are kept small enough to fail (as opposed to too big to fail), the risks of widespread market failure are reduced. Individually, the covariance of small banks has less significance on the financial system. However, collectively they do.

The crisis exposed the universal problem of conflicts of interest, such as with the rating agencies. It is clear, financial 'Chinese walls' simply do not work. Banks have become terribly conflicted institutions as they act on behalf of both principal and agent on numerous transactions, even in some cases when they are highly conflicted. The same problem applies to auditing and accounting firms; the auditing business is just a loss leader to bring in the customers to their accounting business. So, there is an existing institutional conflict of interest here. Now, there will be a general drive to minimize conflicts of interest.

This leads to the enduring Glass-Steagall debate of separating the functions of investment banking with that of the commercial deposits/lending arm. There could be a return to Glass-Steagall as well as an initiative to a return to narrow banking. The scope of global banking could become much more limited and this may become a permanent shift. There could very well be more tight deposit making activities with narrow banking type lending. Everything else would become properly supervised, like that of the investment banking activities.

There is also a need to overhaul the reward and bonus systems. Greed caused investors to buy complex structured products so as to chase high returns but without regard to what they were purchasing and little or no understanding of the risks. Greed also inspired the dealers and investment bankers to sell such products so as to reap the arrangement fees. Greed also motivated top executives to over-rely on poor financial risk models and to take on added risks.

Arguably, this is the best time to bring in strong regulatory rules, since all the institutions are down. The risk of over-regulation is far easier to deal with than trying to impose new regulations when the market is on the rise again. In other words, it is easier to remove regulations than to impose them when the markets are up. Also, regulating innovation and new products will require many actors, not just the regulators.

As a suggested solution, by drawing comparisons with the pharmaceutical industry and the rigorous regulatory approval process for new pharmaceutical products, financial instrument innovations going forth should be required to go through a similar regulated process for initial assessment and investigations into their systemic impacts before general acceptance and introduction into the wider financial system. A financial contract which has not received regulatory approval is one way of demonstrating that it should be avoided.

Islamic Finance Perspectives - Systemic Factors

Throughout the day, participants expressed their individual views of the financial crisis, their thoughts on its causes, its solutions and its impact for the Islamic finance industry.

Though Islamic finance practitioners do feel in a sense vindicated by the crisis, at the same time they were all shocked by the scale of it and of the global impact it is having on all, including that of Islamic finance. All agreed it was very important to be constructive and to bring to the table ideas that can be useful in solving the current financial problems for everyone and not just for the industry.

At the same, there was still a lingering sense of loss of trust. Many were left asking: should Islamic banking be following the conventional model of banks itself?

Some participants felt that the large stimulus packages were just cosmetic aid to more fundamental, root problems within the system. One participant remarked that the global economic crisis has actually been going on for many years now in the form of the growing polarity between the 'haves' and the 'have nots'. As an alternative to the bailout money to financial institutions, one suggested that these same funds should go directly to the poor. Doing so would naturally cause the funds to be recycled back to the banks in the form of actual deposits from the initial recipients, thus both stimulating demand by a new large segment of the population at the same time helping to move the engines of the economy again.

Other suggested lessons of the crisis, in particular with respect to risk management, include: lax risk management practices; under-pricing of risks; high leverage (low capitalization); transferring of risks; creating newer risks; difficulty in assessing

risks in new structures and instruments; the break-down of relationships between lender and borrower; excessive risk taking at the originator level; and lack of control and understanding of the exact nature of assets underlying the securities by investors.

One participant believed the cause of the current crisis was a failure of bank regulation, and not of speculative activity in the stock or currency markets. However, most others felt speculation was a root cause.

All agreed that there were a number of principles in Islamic finance that could have helped avoid many of the issues faced in this current crisis. Also, there are many points that Islamic finance can offer to all. The Islamic finance industry just needs the confidence to assert its points and hopefully people will listen.

Islamic Finance Perspectives - Suggested Solutions

Solutions suggested by workshop participants include: the prohibition of the sale of goods that one does not own (as with short sales); the sharing of risks between all transactional parties; tying all financial transactions to the real economy and productivity; the focus on transactions that create real value, real productivity and real goods & services; the promotion of entrepreneurship in ways that is not at odds with the overriding public interest; and the avoidance of excessive speculative transactions. All parties, intermediaries and investors alike, should mutually share risks and profits, and not simply take the profits while transferring the risks to others. In theory, this action should help prevent the growing rift between the very rich and the very poor. Other Islamic solutions include stressing the ethics of saving; living within one's means; the virtues of sacrifice; and both long term as well as short term planning. One very important solution is to improve trust and trust generating mechanisms.

Other practical suggestions not specific to Islamic finance include: monitoring corporate governance and ensuring the protection of rights of all stakeholders in joint stock enterprises; ensuring transparency, accountability and the flow of information to all concerned; preventing the combination of excessive risk taking coupled with excessive leverage; preventing moral hazard situations whereby profit is privatized and risk is socialized; setting up investment criteria to prevent excessive risk-taking; imposing stringent regulatory capital requirements; requiring greater retention of assets or risks by originators (to minimize credit risks); improving the powers of regulatory bodies for all financial products; imposing more efficient legal and regulatory conditions on the issuing and exchanging of securities or *sukuk* on properly supervised exchanges; tackling the complacency attitudes toward risk, risk calculations and risk assumptions in financial models; encouraging simplicity, clarity and ease of use in financial products; appointing a risk officer on the board of directors for each corporation; ensuring that innovation brings more benefit than harm (to be determined by better screening of financial products); cultivating a risk assumption rather than a risk elimination or risk transfer culture; matching actual projects with their financing facilities; curbing the money creation factor by introducing 100% reserve requirements for on demand deposits; stricter control over inflation and money issuance; emphasize wealth creation and distribution to all and not just the few; assessing systemic and market risk in each transaction as well as the risks specific to that transaction; increasing trust by better guarding reputational risk and better public education; improving human capital skills and training; guarding moral, religious & ethical values to improve trust and reputation; developing broad principles and industry best practices in risk management as well as for finance (especially for Islamic finance); and generally adopting all the positive aspects found in all global financial systems while avoiding the more dubious elements.

Monetary and Economic Considerations

Some felt that current discussions should be about renewing the financial system but not to replace it. While others opted for a new start more along the lines of Islamic ideals.

One practitioner asked, given what has happened, is the Islamic finance industry on the right trajectory. Someone should set the trajectory for each area of Islamic finance, especially for risk management.

For many, the problems being witnessed with the conventional financial system are due fundamentally to the inherent structural problems in the concepts of money and wealth creation. Key to these problems is the disconnect between money itself and the real economy. To create extra legal claims against a reserve is in effect, as one put it, amounts to 'fraud'. Furthermore, the use of interest generates artificial levels of supply and demand for money and risk products, which in turn, affect their inaccurate pricing.

In Islamic theory, risk bearing and risk participation modes of finance and investment are always connected to the real economy. Excess wealth is recycled for use in actual trade, production, manufacture or construction as opposed to simply into interest bearing money instruments. As such, there should be no liabilities mismatch between wealth, resources and goods.

Another important comparison between conventional finance with that in Islamic is that in the former, risk can be separated from the asset. Since risk itself can be separated, packaged and sold on, that in itself creates usury, which is strictly prohibited in Islam. It also highlights the divorce between the economic system and the financial system.

It was suggested that if the value of paper continues to fall due to the exponential printing of money, alternatives like going back to the gold standard should really be looked into. A few participants suggested we should move towards a 100% capital reserve ratio model. Another mentioned a study undertaken in the US whereby sustainable growth without any debt intermediation at all was in fact feasible. Though, the unanswered question remains as to whether it is practical to implement given the rooted global debt culture.

Most argued in favour of separating the commercial banking functions from that of the investment banking activities; financial intermediation would be split between the deposit receiving/payment mechanisms from that of the risk taking investment activities. A number of questions were raised on the issue of narrowing bank and Glass Steagall. But, if one were to adopt a model of narrow banking, it would be extremely difficult to have global banks and to have global banking. Everyone agreed that the financial system should at the very least be an intermediary linking the real economy with it and not morphing on its own.

Morality & Ethics

Part of this crisis is regulatory, part is moral. One argued that the industry should look at the demand side as well and not just the supply side.

In conventional finance, the fundamental failure of the moral sphere is a real issue. Consumers were receiving mortgages they cannot afford, which in Islam is unethical. For the sellers of financial products, greed is a moral issue and is a root cause of the actions contributing to the financial meltdown. Before the crisis, financiers faced a classical moral hazard situation in which taking excessive financial risks was encouraged simply because it was other people's money and the rewards were high.

Islamic finance does focus on demand side issues as well as the supply side. This can include for instance, promoting responsibility among consumers; promoting accountability; providing guidelines on the take up, use and payment of debt; and providing warnings to the dangers of excess. Islamic banking is not just a financial institution but is a spiritual form of worship. Thus, accountability to the Creator is the supreme form of accountability, which in turn forms as a natural enforcement mechanism of such moral ideals. So, regulating the well being of consumers is deemed an important part of the equation. In convention financial, no one governs this sphere.

Nevertheless, there is a global reaction to this crisis on moral terms as well. There are already some initiatives in this respect with the IMF, the World Bank and with the Global Governance Principles as outlined in Davos. One asked, is this a time for all financial industries to join ethical movements and ethical finance and make a common cause for all with the regulators?

Behavioural regulation through the use of law is however notoriously ineffective. In the UK, morality can be influenced by law. But it will not work through direct regulation of morals as people will generally disobey. An analogy of the Victorians was used. They did not legislate morality and behaviour per se, but they did set in place a lot of restrictions, barriers and incentives to guide people into good behaviour.

Shari'a on the other hand legislates morality, but largely through the adherence of specific rules, *ahkaam*, which in turn takes care of issues of morality in the same process. However, the legislation of morality has been one of the great divergences between the West and the Islamic world, as the former really objects to it, but the Islamic states stand for it.

But then again, are not modern conventional financial rules and codes on corporate governance and ethics, as well as professional standards of behaviour already forms of legislated morality in the West? With this financial crisis, current discussions in the market have been gravitating toward ways of strengthening these moral codes.

Introspective Lessons for Islamic Finance

Despite a more tempered impact of the global crisis on the Islamic finance industry, participants acknowledged that no one was immune. There was even recognition that the risk of default still loomed for the Islamic finance industry. It was understood that any Islamic financial system could not separate itself entirely from its conventional counterpart. It was confined and bound to work within that dominant conventional framework.

For instance, one participant believed that Islamic Banks were not flexible enough when markets are in turmoil, such as the current situation, placing them at a disadvantage to conventional banks. When interest rates rise quickly, there is factual evidence to suggest that customers tend to switch their deposits from Islamic banks to higher paying conventional banks. Conventional banks recoup these extra funding costs by increasing their lending margins.

One suggested the industry ought to put out a study on how bad the industry is being (or was) affected by the crisis. It was important to understand the exact cost of the financial crisis to the Islamic finance world and how quick the industry can recover from it. Another purpose behind this study was to serve as a basis for self-examination of the industry's own assumptions and perceptions about itself.

One argued that participants were already incorrectly working from the assumption and perception that the Islamic finance industry was badly affected by the global crisis. Some were already presuming that something with the industry's risk management policies has veered off, or that its financial products are not good enough, or even, that the industry is heading towards the same fate as conventional finance.

For many however, the crisis demonstrated that Islamic finance could avoid many of the errors of its conventional counterpart. Some felt that Islamic finance's own systemic and structural make-up is sufficient to avoid any such pitfalls.

Some even went as far as to say that Islamic finance could fill the global systemic void in finance in the wake of the failure of conventional norms. Or at least, they believed that the post financial crisis world would be one that adopts or benefits from the principles of Islamic finance - though not specifically referring to 'Islam' per se - but under the banner of 'justice, equity and human welfare'.

But such optimism came with a warning. Many believed that if Islamic finance continues to mimic the conventional modes and forms of finance, the industry would easily fall into the same systemic crisis and face the same underlying economic concerns. Many feared that the current range of Islamic risk management tools was already a step too far in that direction. This warning that the industry was already on that slippery track was reiterated throughout the day's discussions.

As such, a number repeatedly cited that the fundamental lesson learned from this crisis was not to mimic its conventional counterpart and to remain faithful to the basic Islamic precepts and principles. One added that the industry should not set

out or seek to prove it can replicate Islamic versions of conventional risk management products. Rather, product development should start afresh and start from the point of what is permissible in Islam and create what naturally flows from it. In other words, it is important to create and devise something new rather than to try to replicate or mimic something that is already prohibited. Doing so, would naturally help evolve the industry for the better.

One *shari'a* scholar suggested that the best approach would be to ask the Islamic banks to be more forthcoming of the exact issues and obstacles faced in their operations so that *shari'a*-compliant solutions could be more readily found. This transparency and open dialogue between all those in the industry would enable in theory for such banks to remain true to the vision of upholding the pure Islamic principles, rather than going it alone and falling into prohibitive traps.

Ideals versus Reality

It was presented that there is an ideal model for Islamic finance and then there is a separate, realistic one. Current industry practice with its array of available products constrained by an overpowering conventional interest-bearing framework could safely be categorised as the realistic model.

The major difficulty for all was defining what exactly the ideal was. One participant put it as meeting the *maqasid al-shari'a*. Yet, no exact models were presented nor any detailed explanation was provided other than stressing the ideal merits of a debt free society linked to the real economy.

Most of the participants believed that that they should work on achieving both models but gradually move toward the idealistic. A few felt that no systemic change was required – in fact the industry should not change anything - but continue as is. Whereas a few others felt that the emphasis should be on moving toward the ideal immediately.

Most agreed that Islamic financial institutions were not working in a vacuum. But had they been doing so, it would have been better than working with the current financial environment. The absence of many of the conventional financial laws and operational systems which are so adversarial or at least inhibiting many of the details, norms and statutes of *shari'a* compliant finance, would arguably have been much better, or at least easier for Islamic finance. An environment free from such obstacles, it is argued, would make it far easier for Islamic finance to operate and to function according to its ideals.

A number of practitioners felt that the industry had inherited and been confined to an 'impure' conventional interest-bearing system, whereby Islam's ideal economic system, its fiscal policies, its legal systems, its accounting framework is all driven by and built upon an interest based framework. As such, it is proving increasingly difficult if not impossible to continue to solve many of the growing challenges the industry faces.

Of those who wanted to move immediately to the ideal, the current crisis served as a great opportunity to do so. Now is the time if the industry wants to be more assertive because the conventional sphere is going through an existential crisis. Furthermore, regulators may be more apt to listen to the industry's suggestions. One participant suggested this is the best timing opportunity to move the standard toward *mudaraba* and *musharaka* type products instead of debt.

Of those who advocated a more gradual approach towards the ideal, one strategy suggested was to continue to gain market share until a significant regulatory shift could be advocated in favour of the ideal. Yet, in the interim process of trying to gain market share, the industry should protect the investments it has made, and therefore use structures and tools that have been taken as a form of legal exception, *makbraj*. As summed up by one practitioner, it all goes back to the issue of principles versus practice.

Others argued that the industry should give itself realistic targets. Beyond that, the industry should have a specific systemic change plan otherwise the current situation will not shift. Policy is something that needs to be thought about and practitioners sometimes unnecessarily burden the *shari'a* scholars with all the decisions of a monetary system.

Many felt the entire matter itself was really an issue of frame of mind. The industry should develop its own mindset and think solely through its own lens. In other words, rather than continuing with the model of trying to learn and to adapt from conventional products (or to 'Islamize conventional products' as one put it), the industry should think outside of the box and develop its own solutions. The industry needs to 'think Islamically' as many put it and to stop being so defensive. This lack of its own financial mindset and of a separate financial thought process inhibited the industry from developing its own organic Islamic solutions and its own course.

However, the negative mindset of some regulators toward Islamic finance even in some Islamic countries, for some, was a major obstacle to achieving progress even on the 'realistic' level of introducing the current array of Islamic financial products.

It's all in the mindset.

ISLAMIC RISK MANAGEMENT

Defining & Categorising Risk

A discussion on the definition of ‘risk’ and its forms took place throughout the day. One participant defined risk as ‘the probability of something undesirable happening that reduces value.’

For some, risk was easy to understand and to categorise. For others, the variety of risks and its distinctions in finance were still being understood. As such, many grappled with the concepts of risk that could be shared and risks that can be shifted or transferred, both in conventional finance as well as in Islamic.

In classical Islamic law, it was suggested that the *shari’a* classifies all risks into three meaningful categories:

1. Essential risk and *al-kharāj bi-dhāman*, which can be roughly translated as ‘the profit belongs to him who bears responsibility’. This maxim encapsulates the concept of risk for return (*al għunm bil għurm*). Parties who enter into an agreement are entitled to its benefit as long as there is some form of associated risk. Without the risk, the transaction would not be *shari’a* compliant. Any condition to the contrary would make the transaction void, such as anything contrary to the rule on (شرط ينافي مقتضى العقد), a total or partial loss or decrease in value of an asset is on account of its owner). If one requires a return of some form, then one should be able to take on the associated level of risk.

In an Islamic sales contract, the seller bears all the risks of loss of the asset until title is transferred to the buyer who then in turn takes on the full risks, including risks of defect, damage or depreciation arising thereafter. In an Islamic leasing arrangement, the lessor assumes all risks of loss (not caused by the lessee) and the risks of maintenance and payments of taxes. Whereas the lessee assumes the risks of rental payment, of any loss of profit and of under-utilisation associated with the rental of the asset. In a *mudaraba* arrangement, the risk of loss, damage or decrease in value of the *mudaraba* assets and capital is borne by the investor (*rab al mal*) as long as there is no default, misconduct or breach by the investment manager (*mudarib*). This is on the basis of the maxim (المال يهلك و يتلف و تنقص قيمته على مالكه).

2. *Gharar Katheer*, which can be roughly translated as ‘excessive/gross uncertainty or speculation’. Muslims are strictly prohibited from entering into this second category of risks as such risks make a transaction or a contract void from a *shari’a* perspective. Whereas in conventional finance, this is a form of tradable risk which can be separated and sold on, or, which can be mitigated against.

This form of risk is also known as *gharar jaseem* (غرر جسيم) and it can be further classified into the following sub-types of prohibited risks:

- a. Risk in Existence (غرر في الوجود) (i.e., the sale of a non-existent item, such as crops, on a future basis);
- b. Risk in taking Possession (غرر في الحصول) (i.e., the sale of a run-away camel or commodity / property that has to be repossessed);
- c. Risk in Quantity (غرر في المقدار) (i.e., sale price or rent being unknown in a sale or lease contract);
- d. Risk in Quality (غرر في الصفة) (i.e., type, quantity or specifications of the subject matter of contract being unknown); and
- e. Risk in Time of Payment (غرر في الأجل) (i.e., a deferred sale without fixing the exact period).

Involvement of any of the above types of risks make contracts of consideration or exchange (*aqood al muawadat*) void with the unanimous opinion of the jurists. In contracts of gifts or donations (*aqood al tabarro’at*), the majority of jurists are of the opinion that these risks make such forms of contracts void, with the exception of Maliki jurists who view

risks in contracts of gifts are permissible. From this Maliki opinion, contemporary jurists have derived that *takaful* is permitted despite containing Risks in Existence, Possession, Quantity and Period.

These risks are deemed excessive and gross in nature as they fall into the categories of gambling and speculation, being some of the causes for the current global financial crisis. Short sales for instance are prohibited on the basis they fall foul of the rule on Risk of Possession; they involve the sale of something (i.e., shares) which are not owned by the seller at the time of the initial sale. Also, the sale and trading of debt falls foul of the above prohibited categories of risks as such activities carry with them additional ('gross') levels of risks, such as the possibility of non-payment of the debt by the actual debtor.

An important corollary to the prohibition on excessive risk is that *shari'a* does not permit a party to intentionally take on such forms of excessive risks and then to hedge against those same risks with the help of some form of hedging or risk management tool, irrespective of whether the actual hedging/risk management tool is *shari'a* compliant in itself or not.

3. The third category can be described as a level in between the former two. This can include a variety of forms of risk, including market risk and operational risk. This is not a risk that is part of a financing tool's inherent structure per se. Therefore, this type of risk can be mitigated against or avoided.

It is recommended that these types of risks, their nature and their classification in Islamic finance be kept always in mind, as they do help when trying to distinguish Islamic perspectives on risk and risk management from those in conventional finance. As such, due to these definitions of risk, some conventional risk management tools and techniques may not always be applicable to Islamic modes of investment and finance.

As mentioned earlier, key *shari'a* principles that should be kept in mind within any discussion of Islamic risk management tools include: that the risk follows the return (الخراج بالضمان); the benefit should involve liability (الغنم بالغرم); and, a total or partial loss or decrease in value of an asset is on account of its owner (يهلك و يتلف و تنقص قيمته على مالكه المال).

With respect to derivatives, the UK Financial Services Authority defines derivatives as forms of contracts for differences. The fundamental problem of the use of derivatives in Islamic finance per se is that in conventional derivatives, there is no intention to trade the underlying but only the difference; whereas this is not possible under Islamic *shari'a*. Hence, this critical distinction is one of the major obstacles to developing this area of risk management.

Defining Islamic Risk Management

Risk management, also known as hedging of risks, can generally be viewed as analyzing the exposure to risks and then either managing, mitigating, transferring, retaining, reducing or avoiding such risks in finance. Some define hedging as any transaction that decreases the risk of one's portfolio. While others argue that simply diversifying a portfolio qualifies as hedging.

A definition of speculation proves even more difficult as a variety of definitions exist. In finance, it may be viewed as assuming the risk of loss for the uncertain probability of receiving some form of reward. The difference is that hedging tends to reduce risk, whereas speculation tends to have the opposite effect of increasing it.

Speculation has always been troublesome in Islam, especially due to the principle restrictions on *gharar* (excessive uncertainty) and *maysir* (excessive speculation/gambling). Moreover, speculative transactions are criticised for not having a real underlying asset or for not being linked to a real economic activity. Given such restrictions and concerns, the development of risk management instruments in Islamic finance has been slow and cumbersome.

With the advent of the financial derivatives market in the 1970s, risk management was promoted as the use of derivatives to hedge or customize market-risk exposures. Thus, sometimes derivatives instruments are referred to as risk management products.

In Islam, there is a lack of consensus among Islamic finance practitioners on what constitutes the 'principles and objectives of risk management', in other words, the *maqasid al-shari'a* of Islamic risk management.

In an ideal sense, Islamic risk management can be considered a highly commendable mechanism. Among other things, it seeks to achieve 'prudence' in the use of resources and the avoidance of waste and damage (which includes economic waste and financial losses). Islamic prudence means the 'aversion of damages and generation of utilities' (*dara' a-mafasid w jalb al-masalib*). In other words, the risk of financial loss is a damage which is assigned a higher priority than the prospect of profit.

However, one participant viewed the very term 'risk management' as misleading and an oxymoron as 'risk' is already an inherent part of all Islamic financial products. Instead, they believed that it should be termed 'risk assumption'. When investors agree to invest, they have actually agreed to assume the risks, in the same way they have agreed to accept profit from the investment. Thus, the principle of managing risk in Islam is to accept the correct proportions of risk in a normal part of a business equation, and to internalize the fact that risk assumption, like profit making, is a natural expectation of investors in all business transactions.

Thus, a paradigm shift in terminology and in practice is needed in Islamic finance. Such a shift it is argued would help create more principled, tangible and financially sound products tied to real assets and productivity. Furthermore, this shift would help prevent the creation of exotic and speculative instruments designed to 'manage' risk, rather than create real value.

Despite this ideal view, most modern Islamic financial tools have been created or are still being created with the purpose of mitigating against specific risks. Islamic financial institutions have to manage a number of pressing risks, such as credit risk, liquidity risk, market risk, foreign exchange risk, and even rate of return/profit risk, similar to the interest rate risk conventional institutions face. Though the assets and liabilities of Islamic banks are distinctive, mismatch risk is still a big threat. Business risks and operational risks which can generate unexpected losses also need to be managed or hedged. Moreover, in practice, Islamic finance faces some additional risks such as ownership risk in *murabaha* and *ijara* contracts, which do not occur in conventional banking. The argument being put forth here is that until suitable alternative and innovative tools are discovered, scholars cannot expect the parties to wait and do nothing.

But, some products like that of total profit swaps were also created to serve as investment tools, which has created further controversy. A few case study examples of each were provided to workshop participants for analysis and comment, results of which are discussed later in this paper.

The Case for Islamic Risk Management

Even by the close of the workshop, it was clear that there were general misgivings about the current array of Islamic risk management tools. As mentioned earlier in this paper, there was a general sense of concern among participants that the Islamic finance industry was simply mimicking conventional products and was not really living up to its own ideals. Much of this criticism has been directed at the current range of Islamic risk management and derivatives products. Most felt that something was not ideal about them, or even, that they may not be ideal at all and should be entirely avoided if possible.

Yet, several participants were in favour of derivatives largely because they could help, among other things, to better manage the liabilities and assets mismatch on banks' balance sheets. Moreover, even if one undertakes a *shari'a*-compliant investment, the liabilities will always determine what the assets are worth. So if a trade loses value, one's underlying assets as an investor also fall in value, and vice versa.

The need to manage such mismatches arises from the premise that the Islamic banks do not exist in a vacuum. The Islamic finance industry remains a very small part of the entire conventional global finance fabric. Islamic financial institutions therefore are not immune to the effects of global interest rate and currency fluctuations and many of the underlying risks associated with conventional, interest-bearing finance. The issue therefore goes back to the discussion on the monetary system.

In theory, Islam should not even be held responsible for proscribing any solutions since the underlying cause, be it interest or currency fluctuations, is impermissible to begin with. As several put it, these problems were created by factors outside of the remit of Islamic finance and the industry is left to itself to devise solutions to them, be it by a form of *hila* or *makbraj* (defined below).

The equation is further complicated by consumer expectations. Most consumers expect to receive a risk management product that is not only *shari'a* compliant but priced comparable to that of a conventional mechanism. Islamic finance is not immune to basic economic factors such as price competition and consumer choice. According to a joke overheard by some in the Islamic financial community, some consumers mistakenly perceive or expect that: "The best Islamic bank is the one with the best rates; wherever one gets the best interest (profit) rate that is the best Islamic bank." Even if not true, Islamic financial institutions are pressured to deliver products that meet high consumer expectations on price comparable to that of its conventional banking counterparts.

In terms of actual risk hedging instruments, there was a difference of opinion as to whether or not use of conventional hedging instruments such as forward transactions were acceptable tools for practitioners to deal with such risks. Most participants felt that it was better to use existing *shari'a*-complaint tools, in spite of their limited applicability and rigid conditions. *Shari'a* based contracts include use of *arboun*, *salam*, *wa'd* and parallel *salam* contracts. But again, such tools are not a cure for all modern financial risks. Trading in currency futures and options is still prohibited.

The main differentiators between conventional and Islamic risk management is the potential for greater risk sharing in latter. Islamic clients are also exposed to residual price risk in the underlying asset, along with the equity risk when and if the bank provides equity finance. As such, a higher understanding of risk management and of their effects is required, as is understanding of the regulatory substance of Islamic and other religious provisions.

Finally, one participant was fearful of the actual use of these risk management products. They feared that use of derivatives was a greater risk in of itself, as witnessed by the fallout caused by derivatives in the current financial crisis. It was agreed that this factor needs to be looked into further.

Given all the above issues, it can be generally concluded that hedging is permissible in *shari'a* if the following three conditions are met:

1. The risks being managed or mitigated should themselves be *shari'a* compliant;
2. Risk management should be by way of *shari'a* compliant means, modes and contracts (as opposed to the use of conventional risk management products); and
3. The objective should be the management, mitigation or lowering of risk only, but not to fully eliminate or to earn profits from such risk by use of conventional styled investment products.

Makharij and Hiyal

To meet the current need for risk management tools a number of ideas were put forward, including the use of legal exceptions, *makharij* and legal strategems, *hiyal*.

Most agreed that there is a clear difference between the use of *hila* and *makbraj* when it comes to risk management. The difference lies between creating tools of exception in order to avoid an imminent and unavoidable *haram* through the use of *makharij* versus creating such tools simply to promote regular profit making through the use of *hiyal*.

Some used the analogy that Islamic finance is currently an industry that is forced to work within an 'impure' system, acting defensively. In order to make it 'pure', complex tools such as those devised through *makbarij* are required. Though rare, they happen to meet real needs.

Participants were reminded by a scholar that *maqasid* do not in themselves decide individual cases; one cannot decide a real case with *maqasid*. A *shari'a* scholar does not practice *ijtihad* on *maqasid* alone.

Many advocated for everyone to make a clear and visible distinction between transactions made permissible by the use of exceptional *shari'a* principles, such as in situations of real need or dire necessity, and highlight them as such to the public, and those transactions which do not employ such mechanisms.

Other suggestions included, promoting the use of strict conditions with derivative transactions (but implementation of which was agreed a challenge in itself); limiting situations where they can be used for pure speculation; and openly discouraging customers from asking for these devices.

Another suggested approach in developing suitable products was to focus on just striking a balance between reducing the corruptive elements, the *mafsada*, and realizing those elements for the common good, the *maslib*, to the extent that even if this approach meant having to include some doubtful matters, *shububaat*, but not any explicit prohibitions, the *haraam*. It was reminded that the concept of gradualism, *tadrij*, was utilized to implement some of the more stringent prohibitions to society in early Islam. The key was to produce Islamic financial guidelines and to promote risk sharing, *mukhatara*, that serve to restore or to maintain a constant, natural equilibrium between sustenance, *rizq*, and risk itself.

The principle of *sadd al-dharai*, or blocking the means to evil, as a mechanism to justify the use of some Islamic risk management tools as a form of protection was also cited.

However, use of all these mechanisms came with a bleak warning. One participant highlighted the fact that historically the Christians used similar exceptional legal devices for certain prohibitions and ended up permanently accommodating such exceptions into mainstream practice.

As such, some participants were very concerned that many of the exceptional *shari'a* principles and mechanisms employed in the design of Islamic financial products are now becoming the norm. In other words, these exceptions are the new norm. For many, this is a very worrying trend.

Market Risks and Credit Risks

Though finance, Islamic finance included, involves a number of types of risks, the workshop discussion looked into whether the emphasis in Islamic risk management should be on market risks or rather on credit risks, which is usually the case for conventional products. The importance of this distinction affected the discussion on risk shifting versus risk sharing, as referred to later in this paper.

The triggering factors in the current crisis have been market risks. Derivative products such as credit default swaps are market risks. So, there was an urgent need to talk about market risks.

The first types of conventional derivatives initially looked at market risks, such as underlying asset price risk. However, more recently, the focus has shifted to credit risks. Given the Islamic finance industry's junior comparative size, it too is following this trend.

Many Islamic products, which are equity based in nature, require credit risk management tools simply because they are intentionally mispriced like that of debt (as discussed later in this report). Therefore, one participant asked whether credit risk is really any different from any other kind of risk.

Another participant took the view that credit risk is an extreme form of risk, which is tantamount to excessive prohibitive uncertainty, *gharar jabish*. In this regard, it is even worse than pure gambling, *maysir*, that is because the probabilities of winning and losing are known in gambling, but are generally very difficult to quantify in the case of credit risk.

Moreover, one cannot tackle credit risk given the nature of interest bearing debt contracts. It is very difficult to manage credit risk regardless of the risk management tools used. For example, this can be seen when the world attempted to tackle the huge size of the under-developed world's debt.

One participant recommended that one of the best risk shifting tools for credit risk is *dhaman*. He also recommended that *ajr bil-dhaman* be used. However, due to problems of control, they should come with a strict condition or warning that they are to be only used out of necessity for hedging and not for purposes of speculation. The fear is that speculators can gamble and take over its synthetic risk, which is not linked to the real economy. However, a number of *shari'a* scholars took issue with the concept of *ajr al-dhaman* and argued this was not even permissible in Islam. Yet, other scholars seem to warm to it if used out of necessity.

Several other forms of risk were discussed including operational risks and systemic risks. One suggested that concentration risk into one key client as opposed to diversifying the client base, remains a key concern for many Islamic financial institutions.

As a related side point, current financial and mathematical models to conduct risk analysis, such as stress testing may need to be revised given this crisis and perhaps build moral issues and factors into the models themselves.

Risk Shifting versus Risk Sharing

Integral to the day's discussions was a debate over the permissibility and preference of risk sharing over risk shifting. Risk shifting plays a major part of conventional finance and forms the basis of many of the controversial risk management products in the financial crisis, including, securitisation and credit derivatives.

As one participant put it, the entire financial system since its inception has been based on one fundamental product: interest, in the form of interest bearing facilities. Risk shifting has been the essence of the structural support maintaining and controlling this product. Furthermore, liabilities in the form of debt handled by the conventional banks, carry significant risks that need to be shifted away from the banks' books; hence, the need for risk shifting.

Investment products in pure Islamic finance theory on the other hand are not liabilities. For instance, in *mudaraba*, depositors of an Islamic bank account using this method have to share the risks as *rab al-mal*; therefore, no risk shifting is involved. There are no liabilities in *musharaka* and *mudaraba* products, but once they are treated as debt products, for purposes of the balance sheet they are classified as liabilities. If one treats these products as equity products, then one is only confined to commercial risk.

It is argued therefore that Islamic finance is all about risk sharing and not risk shifting. Transferring the risk, or risk shifting, is deemed less efficient, unjust and inequitable. Moreover, transferring all the risks on to the producer-entrepreneurs by financiers creates pressure for accelerated growth that is deleterious to the environment. Whereas a system of production and finance based on risk sharing would be more efficient and more equitable in terms of distribution of income and wealth.

Nevertheless, Islamic finance has struggled to operate in the modern financial framework using simply risk sharing methods. Thus, a debate ensued as to the *shari'a* compliant mechanisms and tools to shift the risk.

Some *shari'a* scholars felt that there were ample examples of principles in the *shari'a* and *fiqh* to do both, risk sharing and risk shifting. Thus, it was not a case of one preference over the other.

However, one scholar took issue with this point and advised that there is no shifting of risk in Islam because one could not make an income without sharing or bearing some risk in the process. Moreover, shifting the risk to the borrower but with recourse to the assignor is only permitted within the Hanbali school of *fiqh* and not with the others. Otherwise, if one is to shift risk, one has to have recourse to the assignee and not to the assignor. The assignee has to bear that risk because the associated risk was transferred along with the asset from the assignor as a whole. Otherwise, one must use risk sharing.

In those Islamic financing modes which result in a debt obligation on the customer, it is not correct to argue that all the risks (other than credit risk) are 'transferred' from the financial institution to the customer because these risks have not been transferred by way of contractual debt but by way of an underlying asset sale and purchase from the financial institution to the customer. The customer acquires title and possession of the asset in a *murabaha*, *istisna'* or *salam* contract with the debt obligation and all the associated risks. In other words, the financial institution first bears all the risks related to the asset purchase, and then 'sells' the commodity to the customer with all the risks attached.

One participant suggested a need to re-examine the concept of risk versus return in relation to this discussion of risk sharing or risk shifting. Once an asset has been sold, the new buyer is to assume its associated risks. Furthermore, everyone was reminded that Ibn Rushd once said that every condition in a contract has a consideration and a price. But also risk can be transferred without consideration, as seen in the *waad* and the *dhaman* structures.

Another suggested the need to differentiate between the creation of new risks and the transfer of existing risks. While another advocated that a distinction should be made between the various forms of risk within each different Islamic financial product. For example, in the case of *mudaraba*, the risks associated with the *mudarib* differ from those of the *rab al-maal*. As such, it would be easier to create tools to reduce or to mitigate against these specific risks.

Another scholar argued that the *shari'a* does allow transactions that assume risk transfer because no human activity could take place without some form of risk associated with it. All human activity carries some forms of risk. Even the equity in a *mudaraba* is a form of risk. Yet he qualified his statement by saying that if anyone could find any basis in *Shari'a* to create products solely for shifting of risk for a price, doing so would give Islamic banking a real opportunity to grow in risk management. There was a suggestion of one possible *fiqh* lead, however, the scholar did not elaborate.

As mentioned repeatedly by most of the scholars, as long as there is a genuine economic activity involved, with real assets or an economic benefit to society, in the form of a *shari'a* compliant transaction (as opposed to mere financial transfers), one would face little objections from *shari'a* scholars to such forms of risk management techniques.

One scholar clarified that shifting the risk from the asset may not add *gharar* or *maysir* to the issue. Whereas, in a contract of *muawada*, if one party's profit is based on the other's loss, it is deemed *maysir*. In other words, if one party's return is dependent on or primarily determined on the other party's loss, then one falls foul of the *maysir* prohibition rule.

One participant pointed out that when risk is shifted in practice, Islamic banks do not adhere to the *pari passu* principle; tranching is used instead. Tranching therefore is a cause of the problems here.

Despite the arguments put forth on the issue of risk shifting, participants did feel that the emphasis should still be on trying to promote a culture of risk sharing. Product solutions proposed included structured use of *takaful*, which employs the sharing of risks.

But, even if one were permitted to shift risk, one of the reasons behind the current financial crisis is largely due to problematic shifting of risk.

Hedging & Speculation

Hedging

One participant made an important legal distinction between hedging the types of risks that are actually created by *shari'a* compliant transactions versus hedging against those risks created by non-Islamic factors.

This distinction is critical when practitioners ask for a *shari'a* opinion to hedge against risks involved in prohibited transactions not under *shari'a*, as those would not be sanctioned, versus for an opinion on hedging risks coming out of *shari'a* compliant transactions with *shari'a* compliant tools and mechanisms, which most likely would be authorised. Moreover, by sticking to the permitted categories of risk in *shari'a*, this should itself naturally prevent banks from entering into excessive or speculative products and risks.

One scholar suggested to anticipate risks from the start of any transaction and to work in risk mitigating solutions into the structure, rather than addressing risk management through separate risk management products, as he had done in prior transactions. However, another *shari'a* scholar dissented stating that such an approach would not be feasible in all circumstances or appropriate for all hedging concerns.

Speculation

Many felt that risk management products should be confined to the realms of just hedging and not speculation. However, one participant pointed to the fact that one cannot have hedging without someone speculating on the other side of the transaction. So by just entering into a derivatives contract, one is already encouraging another party to speculate.

In a normal, liquid conventional financial market there are three types of actors: hedgers, speculators, and arbitrageurs. The hedgers try to reduce risk with use of risk management tools, the speculators take on the risk that the hedgers want to avoid and the arbitrageurs look for opportunities arising from market inefficiencies, which lead to pricing differentials. Each plays an important role in their own respect. The arbitrageurs ensure that prices in different markets converge leading to more efficiency. The speculators provide liquidity to the market.

Another participant took a slightly different view on speculators. The behaviour and interests of risk takers (speculators) are very different from those of one taking risks involved in his/her own business, producers, fund owners and financial intermediaries. All four gain by stability in the markets. But the buyer of risks gains by instability. Thus, buying risks involved in other people's business is a speculative activity akin to gambling.

Another warned that with all fixed and floating swaps, all parties seek simply to take advantage of the financial comparative advantages.

Thus, the challenge for the industry is that these risk management products can only work if there are speculators in the market as well. So the question remains: is the industry therefore prepared to facilitate speculation indirectly?

To counter the problems associated with direct speculators in the market, a creative suggestion was made to incorporate conditions into a legal contract stating that there should be a real economic activity behind the transaction in question. Additionally, it was recommended that practitioners undertake careful due diligence of the actual business behind the transaction.

Equity Risks

According to one scholar, *shari'a* has unlimited non-debt based products and not just *mudarabah* and *musharaka*. However, while practitioners use equity based tools like *musharaka* and *mudaraba*, they do not actually use them for equity purposes. Instead, these tools are used in the majority of cases for debt generating purposes, including for *sukuk*. Thus, these equity based products were in effect debt based products. This therefore impacts on the risks and the relevant risk management tools required of them.

By treating them as debt products, bankers are able to price these equity products close to conventional debt rates as opposed to normal higher charge associated with equity risk levels. Moreover, banks by their very nature as debt institutions are in many ways restricted from pricing them as equity products, which in itself, as one participant pointed out, is a major concern for all the modern conventional economists including Keynes and Freedman. Banks cannot focus on doing equity financing because they cannot take on any additional risks onto their books. Again, this is a by-product due the make-up of fractional reserve banking.

Since many Islamic equity based products are treated as debt products, there was a need to discuss why the industry has yet to come up with the right equity risk management assessments to bring these products in line. It was argued that equity risk should be added to the risk management policies of all Islamic financial institutions. Equity risk management goes to the very heart of *shari'a* compliant products in Islamic finance. Participants were unaware of any banks that do this.

Pricing of risk

One major concern about the use of derivatives generally, be they Islamic or not, emanates from the determination of their pricing. Pricing in Islamic banking is still confined to the liabilities and assets on its books.

According to some participants, Islamic banks face an unlevel playing field in terms of pricing dynamics compared with conventional banking. Fractional reserve banking cannot survive without a lender of last resort and/or deposit insurance schemes, which effectively misprices the risk. Moreover, the lender of last resort in effect has a monopoly over money.

Thus, interest bearing debt based on *libor* or the base rate is really the cheapest price one can attain in the financial markets for financial products. One can try to come up with a better pricing benchmark, such as on commodities or a basket of goods and services; however, it will always be more expensive than the subsidized interest rate. Furthermore, every time one attempts to devise a more *shari'a* compliant pricing mechanism, the market will always skew toward to this subsidized pricing rate.

Fundamentally, conventional leverage is not only cheaply priced but there are tax break incentives for using debt. Few would want to use expensive equity based products and few would want to share their upside profits as under a classical *mudaraba* financing when one can obtain cheap loans from the subsidized conventional arena. At more attractive rates, debt creates a “buy-now pay-later” consumer culture, and assists corporates to increase their return on equity for their shareholders. In other words, debt based products are cheaper and make better commercial sense. Moreover, savers are not incentivised to invest in classical *mudaraba* investments. These highlight some of the practical limitations and problems of using equity based products like *mudaraba* and *musharaka*.

With competition from this subsidized rate, Islamic financial institutions are forced to re-design their product offerings. Muslim savers demand the benefits of risk-free accounts in addition to returns. Islamic products therefore become hybrids of the original basic structure. Thus, a *mudaraba*, would in actual practice become a hybrid *murabaha* and an *ijara*, would in actual practice become a hybrid *ijara* product. Normal risks associated with an asset under the original Islamic structures would be removed, such as for example asset and market risks, and the product is just left with that of credit risk. Therefore, the challenge for Islamic practitioners in order to move away from this ‘hybrid practice’ is to find viable alternatives to compete on price compared to the subsidized conventional pricing mechanism. Currently, there isn’t any.

One other practitioner revealed that how he prices a derivative is based on how his bank expects it to behave in the future. The concern with this method is that when he prices it on such a determination, the price itself also affects or even helps to determine the actual real price of the derivative in the future. And this can be a serious concern in *shari'a* as the pricing process is a form of speculation within itself, in effect potentially violating the principles of *maysir* and *gharar*.

Principal – Agent Issues

Issues of conflicts of interest between principal and agent are a real major issue in finance and in law. Even in Islamic finance, the industry has had to make difficult decisions based on these issues.

For instance, there are lingering agency problems with products like *mudaraba*. Regulators do not take into account problems associated with the principal also being the agent. Also, there is the issue of whether to report *mudarabas* as on-balance or off-balance sheet as well as the problem of comingling of depositors' funds with those of the shareholders' capital. Thus, in each of these issues, one is left asking, where does one draw the line?

In the Hanbali *fiqh* (jurisprudential) school, it is permissible for a party to be both the principal and the agent. However, this permission is only available with several stringent qualifications. All schools however say that this conflict of interest can be prevented by proper disclosure and transparency of the full risks involved in this kind of relationship. Parties should be made fully aware of the facts, made aware of the potential for conflicts of interest and should all consent to this form of relationship at the start. But again, without such stringent qualifications, no *fiqh* school permits the principal can be the agent alone.

Regulation

Regulation was discussed at length by participants, both the need for regulatory reform to help move the current market to the macroeconomic ideals as well as regulation to improve the current array of risk management tools and guidelines.

Many agreed that the economic crisis as well as advances in global Islamic finance provides a window of opportunity to stress and to explain adherence to rules and regulations like those published by the IFSB and AIOIFI to everyone, which under normal circumstances would have been detrimental in a competitive environment with conventional markets. Thus, a wholesale market initiative to adopt the AAOIFI standards or similar would be an important contribution. Though, one reminded everyone there are both good and bad economic and financial reasons for taking on a lot of regulation as well as for not taking on any regulation.

There were a couple voices of dissent that were actually very wary of any further regulation (in addition to those imposed by conventional regulators). Another participant believed that the Islamic industry has learned early on what is good for it and what scholars have been always asking it to adhere to.

Instead, there was an appeal to the industry to follow more of the letter and spirit of the *shari'a*.

But what institutional and regulatory arrangements would be desirable? One advocated a move from favouring the debt contracts to more risk sharing, as in the examples of models found in the United States and the United Kingdom for home ownership. Another suggested that Islamic banks should be given the incentives by the regulators to come up with solutions to reflect the *maqasid al-shari'a*. Another discussed the need for a regulator to guard against asset price bubbles generally and to devise a bonus system whereby it is only paid out on a deferred depending on earnings and increasing personal liability.

Even with the current array of Islamic risk management tools, there is a clear need to improve the existing legal documentation and regulatory frameworks. Documentary issues such as early termination provisions, close out netting and collateral arrangements still require improvement as with their enforceability. Moreover, regulatory capital and accounting treatment for Islamic hedging instruments need to be considered. Thus, greater active participation of regulators in this field is required as are the *shari'a* input from Islamic finance practitioners.

Contractual Conditions

There was some discussion of setting conditions with the use of risk management products. By imposing conditions, either in the contract or by regulators, this in theory, could stymie the actions of speculators, risk takers and the ensuing volatility such products could cause if left astray (as witnessed in the current financial crisis with some conventional derivatives).

There was some debate among practitioners as to whether conditions could be stated in the contract themselves as opposed to mere guidelines or regulatory suggestions.

But there was a concern that perhaps these conditions may not work, with an interesting discussion among the practitioners saying if one imposes a condition in the derivative agreements, such conditions may be unenforceable especially to third parties or to subsequent trading parties of those agreements. Moreover, if a condition is added requiring the transaction to have a genuine business need, practically, if there is no ongoing business transaction, then the importance of the condition would fade away.

Then there was one final solution put out: the sharing of risks with *takaful*. But the feeling was that such as a solution may be expensive and would not occur without some kind of systemic limit on other kinds of risk management tools involved. However, there was a follow up suggestion that the regulators should undertake to facilitate such ideas and structures.

Waad, Commodity Murabaha and Tawarruq

One *shari'a* scholar recommended that the industry use *waad* for hedging purposes, but not for speculative purposes. But again, with hedging, there is usually a speculator on the other side as well. While another participant had specific concerns with the current usage of *waad*, arguing that it can actually amount to an impermissible forward contract.

One *shari'a* scholar recommended that the industry should try to avoid continued use of commodity *murabaha* as much as possible. The reason being is due to how it was devised. A commodity *murabaha* was originally designed on the basis of a legal exception and to be used only in dire need and necessity. Its continued utilisation also has many other unintended and difficult *shari'a* and legal consequences to deal with. For instance, a parallel commodity *murabaha* can potentially face *shari'a* challenge if for instance there is a default in one part of the structure, this can automatically default the rest of the structure, which is impermissible in *shari'a*.

Furthermore, there was a call to further investigate the ramifications of the use of two-tier *mudarbas*. It was felt that there was still a clear disconnect between the structure and its use.

At the same time, it was suggested (by practitioners) that the industry should not over-burden the *shari'a* scholars with queries as to why they permitted commodity *murabahas*. Yet at the same time, the industry should be asking itself whether there is a real need to develop better alternatives or not.

It was also revealed that practitioners themselves face a lot of criticism as to why they need to use a *tawarruq* transaction in order to provide any rate hedging solution. The difficulty of finding alternatives lies with the dilemma that from a *shari'a* perspective, banks can only pass the intended benefit and proceed through an asset sale mechanism. Otherwise, without this sale transaction, financial institutions are either giving the money away as a loan, which is strictly not permissible in *shari'a*, or there is no real economic transaction occurring between the parties. Therefore, it has been argued that the current best and easiest solution and to meet a real genuine need for such products, hedging is undertaken through use of a *tawarruq* transaction. Nevertheless, bankers were amenable to discovering better mechanisms to achieve the same purpose, but without the negative complications associated with a *tawarruq* transaction.

Takaful as Hedging Tools

Another solution to managing risks, both without the use of controversial structures such as *tawarruq* and which is still in line with basic (*shari'a*) models, is that of a *takaful* solution.

The concept of guaranteed insurance was suggested by a participant. These structures may be used for cooperative hedging purposes. However, a number of practical problems to their implementation were highlighted.

First they are difficult to regulate and to monitor. Another issue is that there is hardly anyone on a global level to underwrite this form of risk. Many of the companies who were underwriting, either on the secondary re-insurance market or on the re-*takaful* market, said they didn't understand this business model. Thus a major market education hurdle needs to be achieved.

Additionally, the risk to be underwritten is a lot more expensive than can be found in the derivatives market. Thus, even if the *takaful* was agreeable, it could be as one practitioner advised, 50 or 100 basis points more expensive than what one could achieve using a basic *tawarruq* structure. The question is, as with other 'equity based' risk management products, are consumers willing to pay for such an added premium? Even if the answer is yes, due to pure on demand/supply factors, the take up such products could be less than that of *tawarruq* or other cheaper debt alternatives.

As has been repeatedly discussed, there is a need to seek alternative solutions to the current Islamic risk management tools. Alternatives might be in the beginning costlier, more difficult to implement or even still have loose ends from a *shari'a* point of view, but the initiative to find such alternatives is worth, the risk, so to speak.

Concluding Thoughts

As one participant correctly summed the workshop, what is emerging here is a plea; a plea for intelligible *quma'id* (theoretical maxims) middle level explanations from the Islamic finance industry, both for solving its own risk management dilemmas but also to aid the conventional arena with its own thinking especially after this financial crisis.

The *makbarij* are provisional tools to meet actual needs. Moreover, there are changes happening through the application of various proscriptive rules, *ahkaam*, with exceptions. As one scholar stated, the industry is trying to design a system that has the mechanical way of keeping itself. But, without the reliance on ethics and without ethics, no system can work.

Some of the participants have said, let us be realistic, we have to move ahead, either abandon Islamic finance altogether, or use these creative means to bypass the obstacles in the interim. For this group, the industry has to look forward to a change as Islamic finance grows in the future and is faced with more complex challenges.

But others felt that nothing can fundamentally change substantively in Islamic risk management or perhaps in any other field pertaining to Islamic finance, as with *tawarruq*, until more systemic, regulatory changes are made, with an immediate end of the debt culture.

CASE STUDY – Review of the Main Islamic Risk Management Structures

(Profit Rate Swap, Currency Swap and Total Return Swap)

Participants were all provided with a case study prior to the workshop which asked a number of questions pertaining to three common structures used in Islamic finance risk management, namely, profit rate swaps, currency swaps and total return swaps. The following is a collation of the answers provided by some of the workshop participants to the questions raised in this case study. (11 of the 33+ participants only completed the study).

Concerns and key issues raised by participants on these three structures:

- Risk versus returns is important.
- Derivatives transfer risks, but sometimes the parties don't fully understand those risks.
- Assets are not speculative, but those who trade or own them are speculating, which is the real cause of the risk, not the structure itself.
- Limitations on the pricing and risk calculation models as the cause of the mistrust and systemic risk.
- They mimic conventional products – there is a need for the products to be based on real assets and we need to move away from mimicking conventional products.

Solutions proposed by participants to the above concerns:

- Limit risk management tools for hedging purposes and not for speculation;
- Some say avoiding speculative products altogether and better regulation of them;
- Some suggested better education and understanding of the affects of these products, better understanding of the actual exposures and the terms of the contract that parties are actually entering into;
- Need for better evaluation of the assets;
- Better to identify the conflicts of interest at the outset;
- Suggest for an alternative pricing authority, but no need for a central pricing authority;
- Parties can take greater responsibility and a more balance approach, which will lead to better operational risk management;
- More effective regulation;
- Better legal frameworks;
- Clearer instructions of the purpose and the risks and the default scenarios that the parties are entering into;
- Reducing undesired risk, even if it means reducing the expected return;
- Cooperative hedging forms have to be started;
- Restricting Islamic hedging products to only those who have only real economic exposure to the hedge.

CASE STUDY - Review of the Main Islamic Risk Management Structures (Profit Rate Swap, Currency Swap and Total Return Swap)

Q 1: Why do you like about these structures?

- Same reasons as in conventional: These products are good for managing mismatches of balance sheet liabilities and assets, the ability to swap fixed for floating returns, we have to start from somewhere to manage risks and as flawed as they may be – they are a start;
- Some suggested they were easy to understand;
- Some suggested they can be used for fixed/variable rate financing;
- The profit rate swap and currency rate swap structures are more widely accepted than the use of *waad*;
- They help to mitigate risks;
- Again, some felt they were good for swapping fixed for floating returns;
- For the total rate swaps – the more controversial structure - some felt they were flexible and could give a good rate of return on an index.

Q2: What are the concerns for these structures?

- Concerns for the link between real assets and real economic activities;
- An over-reliance on *tawarruq* and all the issues we discussed in the previous Harvard-LSE workshop on *tawarruq*;
- These products (profit rate swaps) may lead to free gambling as no link to a true economic activity is required;
- Endorses higher transaction costs and higher operational efforts to achieve than that equivalent of an interest rate swap;
- Commodities bought at the beginning of the period affect the balance sheets. When using a *murabaha* structure, one is holding a large amount of assets on one's balance sheet before it is sold off as per the *murabaha* structure. As such, this can be a real problem for many;
- The fixed portion is for the whole period of the transaction, so there are issues and difficulties with terminating/unwinding the transaction;
- Currency rate swaps - Though they give some value, even if they are Islamic, they involve two separate currencies and thus two separate interest rates economically in order to determine the exchange rate level;
- Total Return Swaps – Concerns that its structure can lead to excessive uncertainty and Basel II capital adequacy requirements;
- They can be used to produce returns from non-*shari'a* compliant indices;
- Someone suggested that a *shari'a*-arbitrage in the *waad* structure, where one party views it as a binding contract while the other views it only as a promise, is a serious issue;
- Someone suggested this structure may amount to a forward contract which is impermissible;
- It unwinds all *shari'a* prohibitions and makes Islamic finance limitless. So to use this structure, the door is open for anything;
- Q3 skipped because it does not add any value.

Q 4: Although the structures may be deemed *shari'a* compliant, there may be a priced according to conventional interest rate movements. Can Islamic finance ever break free from this and what concrete alternatives do you propose?

- Breaking free from conventional pricing requires regulatory intervention, a theme proposed many times this morning;
- *shari'a* arbitrage in the *waad*, on party views it as binding contract and the other only sees it as a promise;

- There is natural demand/supply factors in the Islamic swap market, so let the pricing be determined naturally in the market and this issue will solve itself;
- Someone suggested we really need to focus on finding alternatives to libor and interest rates as reference benchmark for pricing – this itself is the key to developing Islamic derivatives properly;
- Independent pricing can only be done when the back end trades are done the same;
- Sovereigns can take the paths by offering GDP linked bonds to create new markets which will encourage this new alternative pricing mechanism;
- Since there is no liquid market for Islamic forwards and because the arbitrage pricing theory does not apply here, this is why pricing is still based on conventional parameters.

ATTENDANCE

- Habib Ahmed, Sharjah Chair in Islamic Law and Finance, Durham University, Durham, United Kingdom
- Mohamad Nedal Alchaar, Secretary-General, AAOIFI, Manama, Bahrain
- Ijlal Alvi, Chief Executive Officer, International Islamic Financial Market, Manama, Kingdom of Bahrain
- Saud Ammari, Minister Plenipotentiary, Royal Embassy of Saudi Arabia, London, United Kingdom
- Daud Bakr, Shari'a Supervisor, Kuala Lumpur, Malaysia
- AbdulKadir Barkatulla, Shari'a Supervisor; London, United Kingdom
- Ahmed Belouafi, King Abdul Aziz University, Jeddah, Saudi Arabia
- William Blair, Professor of Law, London School of Economics, London, United Kingdom
- Willem H. Buiters, Professor of European Political Economy, LSE, London, United Kingdom
- Howard Davies, Director, London School of Economics, London, United Kingdom
- David Dew, Dy Chief Executive Officer, HSBC Amanah, Dubai, United Arab Emirates
- Tarek El Diwany, Zest Advisory LLP, London, United Kingdom
- Mohammed Elgari, Shari'a Supervisor & Professor, King Abdulaziz University, Jeddah, Saudi Arabia
- Husam El-Khatib, Mayer Brown International LLP, London, United Kingdom
- Nicholas Foster, Director, Centre of Islamic & Middle Eastern Law, SOAS, London, United Kingdom
- Michael Gassner, Vice President, Bank Sarasin & Co. Ltd., Zurich, Switzerland
- Rafe Haneef, Executive Director, Fajr Capital, Kuala Lumpur, Malaysia
- Hussain Hamed Hassan, Shari'a Supervisor, Dubai Islamic Bank, Dubai, United Arab Emirates
- Masarrat Hussein, Group Chief Risk Officer, Abu Dhabi Islamic Bank, Abu Dhabi, United Arab Emirates
- Imran Iqbal, Head, Islamic Products, Saudi Hollandi Bank, Riyadh, Saudi Arabia
- Esam M. Ishaq, Shari'a Supervisor; Manama, Kingdom of Bahrain
- Mohamad A Laldin, Executive Director, Int. Shari'a Research Academy for Islamic Finance, KL, Malaysia
- Kamal Mian, Head, Islamic Finance, Saudi Hollandi Bank, Riyadh, Saudi Arabia
- Mohammad Iqbal Nadvi, Shari'a Scholar & Chairman, Islamic Finance Advisory Board, Toronto, Canada
- Mansoor Shakil, Director, Al Rayan Investment LLC, Doha, State of Qatar
- Laiq Siddiqui, CEO, Amana Canada Holding Inc., Toronto, Canada
- Zohaib Patel, Fajr Capital Limited, London, United Kingdom
- Seif el-Din Tag el-Din, International Association of Islamic Economics, Leicester, United Kingdom
- Haytham Tamim, Chairman, Islamic Consultant & Shari'a Scholar, London, United Kingdom
- M. Imran Usmani, Shari'a Supervisor; Karachi, Pakistan
- Frank E. Vogel, Founding Director, Islamic Legal Studies Program; Harvard Law School
- Nizam Yaquby, Shari'a Supervisor; Manama, Kingdom of Bahrain
- S. Nazim Ali, Director, Islamic Finance Project, ILSP, Harvard Law School