# Mr. Ali Ashraf Afkhami’s (BIM’s CEO) speech paper for the coming ADFIMI’s event

# Comparison of Musharakah and conventional financing with respect to risk mitigation in SME financing

**Abstract**

Islamic banking is interest free banking which makes it necessary for Islamic banks to take active part in the operations of the business, i.e. share profits as well as losses. Banks including Islamic banks prefer to take minimum risk. On the surface, it may seem that Islamic banks face more risk and hence, will have more volatile or even negative returns on their assets. What is true is that risk is an irrevocable part of banking industry and Islamic banking encounter different types of risk because of special nature of Islamic contracts. In recent decade, many tools and methods have been designed to manage risks. Now the question is that whether Islamic banks can use the tools that are common in conventional banking system, to manage their risks? If not, how these tools can be modified according to the Islamic rules?

In this paper we want to explain how do Islamic banks manage Credit Risk when reclassifying of a non performing loan (NPL) is not allowed in Islamic banking? Or how Islamic banks manage liquidity and the associated risks?

**Introduction**

1. **SMEs and SME financing by banks**

Small and Medium Enterprises (SMEs) are [companies](http://en.wikipedia.org/wiki/Company_(law)) whose personnel numbers fall below certain limits. The abbreviation "SME" is used in the [European Union](http://en.wikipedia.org/wiki/European_Union) and by international organizations such as the [World Bank](http://en.wikipedia.org/wiki/World_Bank), the [United Nations](http://en.wikipedia.org/wiki/United_Nations) and the [World Trade Organization](http://en.wikipedia.org/wiki/World_Trade_Organization) (WTO). Small enterprises outnumber large companies by a wide margin and also employ many more people. SMEs are also said to be responsible for driving innovation and competition in many economic sectors.

Since SMEs deal with entrepreneurs’ role in the society, the economic and banking importance of SMEs sector is well recognized in academic and policy literature. It is also acknowledged that this sector is under-served, especially in terms of its’ required financing needs. This has led to significant debates on the most efficient means to serve this sector.

SME finance is the funding of above mentioned enterprises as such, and represents a major role in business finance – in which capital for different types of firms are supplied and acquired. Capital is supplied through the finance market in the form of equity/corporate bond issues, bank loans and overdrafts; leasing and hire-purchase arrangements; as well as taking the advantage of venture capital or [private equity](http://en.wikipedia.org/wiki/Private_equity); and asset-based finance such as factoring and invoice discounting.

1. **Islamic Banking**

Islamic banking was first introduced in late 50s. Since then, Islamic banking is growing rapidly throughout the world and has been introduces in more than 60 countries so far. Global financial players are also participating in Islamic banking and financial industry. Islamic banks provide financing which is backed by assets.

Some major features of Islamic banking are as follows:

* Islamic banks cannot deal in papers. All financing provided by Islamic banks results in the creation of assets i.e. capital formation. Islamic financing due to the asset backed nature results in productive economic activities; hence, it does not result in inflation. Furthermore, the created asset collateralizes the loan transaction provided by Islamic banks.
* Islamic banks need to comply with regulatory standards as well as Shariah rules. Shariah compliance is strictly followed by Islamic banks. This dual check covers the legal risk as there is a doubt check on money laundering and other fraudulent activities.
* Islamic banks are not merely interest free. Interest free nature of Islamic banks is a necessary condition for Islamic banking but not the sufficient one. Clean borrowing is not allowed in Islamic banking. Islamic banks provide financing only to create assets. Therefore, Islamic banks do not preferably offer credit cards, personal loans and running finance / overdraft.
* Islamic banking does not permit transactions in most derivatives. Futures trading in stock and commodity markets, currency options, currency swaps, short selling and other complex derivatives are not allowed in Islamic banking. However, Salaf (advance sale / Purchase) and Istisna (project financing) are such effective solutions that cannot be easily replaced by future contracts in conventional banking. Derivatives have proven to be little effective for hedging and were the main factor behind economic fallout in East Asia in 1990s and in US and other developed markets in 2007.

**C) Differences of Islamic and Conventional Banking**

These differences can be classified in five categories:

### Emphasize on real asset based contracts

Islamic banking uses asset based contracts by removing interested contracts in providing facilities to individuals as well as corporations. I.e.: contracts such as Murabaha/installment sale, Ijara/buy back, Ja’alah,etc. In these contracts, at first a good or service is produced in real economy; then a bank delivers it to a customer by providing its cash price. Therefore, these contracts cannot precede real economy at all.

In general, Islamic banking uses partnership contracts instead of interested loans and participates with entrepreneurs. Obviously, transactions in this sector are in the framework of real economy, and in other words bubble credits do not exist.

### Using Profit/Loss sharing system instead of fixed interest

By the views of all economic experts, face and contractual interest rates are functions of real interest rates in long-term, and are derived from money market in short-term contracts. Consequently, bank interest rate is formed as an exogenous variable in money market and is imposed on real economy. However, by removal of interest, Islamic banking uses the variable of profit of real contracts derived from goods, services, and capital markets.

1. **Supervision on utilizing of bank credits**

In Islamic banking, contract subject must also be met rather than meeting customer identity and his ability to pay the contract to create a real contract. A bank, as the attorney of a depositor, must ensure about technical and economic justification of financing projects. These will be ascertained by effective supervision of banks on activities of depositors. Although this supervision compels extra costs on banks, but in contrast, it prevents entangling banks in non viable projects, and so it helps economy significantly.

**4. Asset based financing in Islamic Banking Vs Credit based financing in Conventional Banking**

It should be noted that Islamic finance is not money for money finance. It is money for goods and services; and goods and services for money finance. This means that Islamic financing will always have real affects due to its constant link with economic activity. This is in contrast to the Conventional finance where a large portion of finance comprises of money for money transactions. Such money for money financial transactions where goods and services do not directly come into picture at the transactions level may or may not contribute to real economic activity. While the financial sectors in Conventional Banking systems have been growing fast, but its benefits have not been reflected in some key aspects of economic development such as in job creation, poverty reduction and in achieving social justice.

**5. Diversity of products and financial inclusion**

Islamic finance provides a more diversified set of financial products compared to conventional finance. The seemingly large variety of modes and products available under the conventional finance gives a wrong impression of its diversity. While many different kinds of financial products for satisfying the needs of economic agents can potentially exist, the reliance of conventional finance on interest has resulted in the strange phenomenon of narrowing its options in products. Almost all financing under the conventional financial system is now based on only one mode: interest based debt instruments.

As opposed to this, Islamic finance has a variety of modes of finance that can be combined in various ways to produce larger variety of financial products to suit the needs in wider range of applications. These modes evolve from and are based on the real economic needs, not from money for money transactions.

## D- Musharakah: Partnership Contracts in Islamic banking

Many Islamic financial experts believe that the performance index of an Islamic bank is usage of participation contracts, or participation in profit & loss of its customers. They believe that the more the shares of partnership contracts, direct investments, and interest-free loans, we will be closer to Islamic banking. In contrast, the less their shares, we go toward interested banking system. In fact, the most concern is that fixed-return contracts are not compatible with Islamic lessons. Discussing about partnership contracts, we first point to partnership contracts in most Islamic banking system.

In fact partnership contract brings suitable results for economy of the country by itself such as alleviating poverty, accomplishing social justice, decrement of production costs, increment of production and supply, increment of investment and employment. This is while if we use real partnership contracts, banks must enter to real economy sector and accept its related risks.

In some countries there are 2 major types of participating (Musharakah) contracts in their banking system:

## D-1- Legal (Equity based) partnership

Legal partnership is about financing required financial resources for production, commercial, and service stock companies by purchasing some portion of their shares by banks. In legal partnership, bank resources are converted to assets (company stocks), which may be easily liquidable. Thus, legal partnership facilities will be reimbursed even if they have not suitable profits, so their credit risks are low. In this kind of contracts investors participant in any profit and loss with respect to their share which is fully compatible with Shariah rules.

Islamic financial banks offer instruments based on equity investments. The two contracts generally used for these instruments are Mudarabah (partnership) and Musharakah (joint venture partnership). Equity investment risk arises because of a potential decrease in the fair value of the equity position held by the Islamic firm.

A firm’s equity partnership can range from direct investment in projects or joint venture businesses to indirect Shariah compliant investment, such as in stocks. If the firm faces a decline in the value of its equity position, it can lose any potential return on its investments and may even lose its invested capital. This situation can trigger additional problems, such as credit risk and liquidity risk.

The Islamic firm can try to reduce equity risk by analyzing certain key factors, including the following, before entering a contract:

* The background and business plan of the managing partner or management team
* The projected legal and economic environment in which the project will take place

In addition, the firm must continue to monitor the investment after such contract is signed to avoid information asymmetry with its partner(s).

## D-2- Civil partnership (Project based participation)

Civil partnership is a type of participation in mutual assets which literally means sharing. In the context of business, it refers to a joint enterprise in which parties share the profit and loss of enterprise. It plays a vital role in financing business operations based on Islamic principles, which prohibit making a profit on interest from loans. In banking network, a customer must announce his civil partnership expected profit rate to a bank in written, and bank evaluates the project by conducting a feasibility study including: 1) Technical report of project; 2) Market study report; 3) Financial appraisal report.

A civil partnership contract may be administered by the bank or the customer. The analysis and monitoring of the project by banks will decrease probability of failure. In fact, in regards to the important role of banks in administration of projects, credit risk of civil partnership will be decreased; however, it will not remove such a risk completely.

**Problem Statement**

Islamic banks cannot merely lend money to earn interest as interest is prohibited in Islam based on Quranic injunctions. Islamic banks are obliged to take active part in the business and opt for sharing profits as well as losses since interest based investments and borrowings are not permitted in Islam. Since, Islamic banks can not charge a fixed return unrelated with their client’s operations, it may seem that Islamic banks face more risk and hence, will have more volatile returns on their assets as they have to own the asset before they sale or lease it to their clients and take on subject matter risk which conventional banks do not take.

**Major Risks and their Mitigation methods in Islamic Banking**

The major risks faced by Islamic Banks include:

**Market (Price) Risks:** Market risk is the most important risk that the goods will not be sold or sold at prices which may not cover costs. This risk is merely borne by the seller when the goods are held for trade. In Musharakah, operational risk is not taken by the bank. Destruction of property is the only risk taken which is very remote. It is covered through insurance, the cost of which is added in the in-transfer pricing. If the tenancy and sale contract were not made dependant, the banks would have taken market risk which the bank avoids by making both contracts dependent and locking the price at the outset. Similarly, delivery risk is borne by the exporter as he does not get the payment until he supplies goods in order.

**Rate of return Risk:** Rate of return risk arises because of unexpected changes in the market, which adversely affect a firm’s earnings. In a conventional financial institution, returns are fixed; both the firm and fund providers know in advance what their returns will be. In Islamic banking, returns are uncertain and investors share both profit and loss with the institution.

If the firm or project fails to respond to the market rate increase, that failure may lead to liquidity risk (because customers may withdraw funds too rapidly). If it responds to the market pressure, it creates displaced commercial risk and must take the steps outlined in the preceding section.

**Liquidity Risk:** Islamic banks usually have excess liquidity. General regulations compliance combined with Shariah compliance result in slight intermediation inefficiency in Islamic banks. It is partly due to the fact that most of them are new entrants and are in the process of converting their equity base into productive revenue generating assets. Furthermore Islamic banks cannot invest in highly leverage companies. They normally invest in companies having a 60:40 capital structure. It makes their equity investments naturally less risky.

**Reputation Risk:** This risk is mitigated through the consensus built among influential religious scholars and ensuring Shariah compliance, which is in essence ethical compliance.

**Exchange Risk:** Exchange risk stems from the unavailability of currency options and currency swaps in Islamic banks. This risk is covered through Forward Rate Cover to fix the cost of the imported goods in Usance LC.

**Concentration Risk:** Islamic banks practically provide financing using Ijara and Murabaha. Most of the financing provided in international trade to commercial enterprises is by way of Murabaha. But the product has minimum risk as compared to Modarabah and Musharakah, which has more tendency to equity financing than debt financing.

**Commodity Risk**: This risk refers to the uncertainties of future [market values](http://en.wikipedia.org/wiki/Market_value) and of the size of the future [income](http://en.wikipedia.org/wiki/Income), caused by the fluctuation in the prices of [commodities](http://en.wikipedia.org/wiki/Commodity).

**Credit Risk:** One of the common risks in each banking system is “Credit Risk”. In the recent decade, many tools and methods have been designed to manage this risk, which one of them is “Credit Derivatives”. Credit derivatives method is used by conventional bank in different methods. In the related references for risk management, credit risk is translated as a risk in which a borrower is not willing to pay his loan or debt according to the conditions of contract. So, payments are paid late or not paid at all and this creates problems in circulation of cash money. In practice, credit risk is measured by calculation of replacement cost of cash flows in declination of customers.

Because of its broker nature, Islamic banking encounters with credit risk as like as conventional banking. In fact, credit risk is irrevocable in banking activities. To demonstrate credit risk in Islamic banking, we study the reasons of creation of this risk in banking contracts. In other hands since clean borrowing is not possible in Islamic banking, Islamic financing is asset backed and adequately collateralized. Furthermore, title of ownership resets with the bank in Ijara and Murabaha until the actual sale transaction is made. Therefore, an Islamic bank can foreclose the asset in case of default.

Since credit risk is the most important risk in all banking systems we have explained different methods we use at Iranian banks to mitigate this specific risk as follows:

## Credit risk management tools in Conventional and Islamic banking with respect to SMEs financing

Conventional and Islamic banking can either identify different dimensions of credit risk or manage them by special tools. The most important methods to avoid or decrease credit risks in Islamic banking are:

1. **Bond and guarantee:** If, in a loan contract or any other debt contract, there is a condition that the debtor mortgages something or a bail near the creditor, this condition is not forbidden even if it is expedient for the creditor. Thus, mortgage and bail are two important tools for management of credit risk.
2. **Default penalty:** Considering default penalty is another method to decrease their credit risks. However, if inflation rate of a country is high, this delay has economic benefit for debtor and default penalty will somewhat lose its effect.
3. **Credit Scoring:** This method is a preventive action to decrease adverse selection that is used by international banks and credit institutions. In fact, some professional institutions proceed for credit scoring regarding to financial situations and credit records of companies. Granting facilities to those with higher ranks decreases credit risk significantly.
4. **Loan loss reserve:** Loan loss reserves are amounts that banks reserve against their expectable credit losses. When a customer will not repay his installments, the related bank has not any problem and removes its problems by referring to that reserve.
5. **Credit derivatives:** One of the common tools to manage credit risks by banks is credit derivatives. These are contracts that their returns depend on credit values of one or several companies or governments, and they are used to manage or transfer credit risks.
6. **Group loan:** In group loan, loan is granted to a group of individuals. In this case, since all members are responsible against the project, they try to find a better project with more suitable risk. Combination of them equalizes risk and increases reimbursement potential.
7. **Full Review and analysis of the applicants:**

Prior to appraisal of the project, it is proposed to evaluate the applicants in regards to his qualifications such as financial status, knowledge, skills and experience, managerial capabilities and reputation.

1. **Full review of the project:**

It is strongly recommended before undertaking any activity every entrepreneur has to first make a business plan for his project. This needs to be a detailed analysis. It has to be a very professional research oriented endeavor. It is suggested that one must take the help of an expert in this. It is not only our suggestion but it is our recommendation. Project report must be made with an objective that the appraisal of the project and its financing becomes easy and smooth. Project appraisal is the assessment of the project by the concerned bank in terms of its technical, economical, financial, political, environmental, social and legal viability.

Followings are the sample questions that shall be replied through the appraisal process:

* What kind of technology the company is implementing?
* What is the industry position? Is it a growing and emerging industry?
* Are the products and technology is competitive?
* Is the technology is a green technology?
* Are there any growth opportunities available?
* Is the project scalable and has development opportunities in the future?
* Is the project economically and commercially sustainable for a longer period of time?
* Is there a proper allocation of resources? What is the status on demand and supply analysis?
* What about the identification of the target market and choice of the marketing strategy?
* What is the process of procurement of raw materials?
* What is the process of manufacturing and value addition?
* Is there a design and layout of the facilities of the project site?
* What is the choice of location of the project?
* What about the environmental appraisal of the project?
* What is the outlook of the business for 20 years from now?

In fact the project must give the details of the financial projection on:

(a) The cost of the project including Capex and Opex,

(b) The means of finance,

(c) Estimation of working capital,

(d) Profitability projections and estimations,

(e) Balance Sheet projections,

(f) Projection of sources and uses of funds,

(g) Social Cost Benefit Analysis.

Beside the evaluation report there should be another analysis which is mainly focused on assessing different types of risks. By some complex mathematical and statistical methods we reach to one significant total risk score of the project. Since the main risk taking levels for each category of industries is annually defined by top risk committee of BIM, the decision makers shall easily decide which projects are allowed to be financed.

**Distinct features of Risk Management in Islamic banking and Conventional banking with respect to SMEs financing**

In conventional banking, loans are defined with a particular interest on bank contract and bank gives loans in exchange for collateral. It means contracts are signed with fixed interest rates and in order to avoid any failure to repay the credit facilities, banks usually attempt to get collateral.

On the other hand in partnership (Musharakah) contracts, primarily interest rate is indeterminate but, could be pre agreed as per expectation as well as sharing the loss while the nature of collateral in Islamic Banking is guaranteed by the assets created through project.

In Islamic banking, according to its characteristics, the initial evaluation and approval process is a critical milestone, because the banks are only willing to accept moderate risk. In other words, only those can take advantage of the banking facilities that have the required banking records; those who have relevant information on the present and future plan. In fact what we do in Islamic banking is evaluating the project as well as the person asking for the loan. Project appraisal is a generic and structured term that refers to the process of assessing. In short, project appraisal is the effort of calculating a project's viability.

**Conclusion**

Islamic finance in principle can contribute to economic development through the same direct and indirect channels. However, because of its design principles and emphasis on moral behavior it has the potential to avoid the problems of disconnect between the financial and real economic sectors. A disconnect which has resulted in financial growth without employment growth, increased inequalities, excessive indebtedness and instability. Islam promotes markets that are based on moral principles: seeking mutual gain and win-win outcomes that make the two parties of trade better off. On the other hand Islamic finance principles of profit and loss sharing automatically adjusts the cost of finance according to the payback capacity of the project.

To sum up:

* Islamic and Conventional banking are both profitable and take the advantage of risk management methods in order to maximize their return.
* Conventional banking is fixed interest rate based focusing on collateralization.
* Islamic banking is interest free, equity / asset based contract focusing on project appraisal and monitoring
* Islamic Banking is based on profit and loss sharing.

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