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FORMS OF ISLAMIC FINANCE AND RISK SHARING

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Abstract:

A characteristic difference between Islamic banks is that they do not base their activities on loans and borrowed funds, but rely on such methods of financing as deferred (or instalment) sales, *murabaha* and *Ijarah*, as well as such types of partnership as *musharaka* and *mudaraba.* [1] In addition, Islamic banks adhere to the basic principles of Islamic finance, the most important of which is the prohibition of usury, and also the fact that the parties must share profits, losses and risks.

The problem of profit, loss and risk sharing raises a number of important research questions about the existence of control on the criteria for this sharing and requires a statement of the Islamic law logic in respect of guarantees between the contracting parties. On this basis, the article is devoted to the study of the Sharia idea for the provision of guarantees provided by the parties, explaining the essence of the contracts in which there is sharing of risks and contracts in which a particular party is responsible for losses, indicating the impact of these issues on the activities of Islamic banks and their competitiveness in comparison with commercial banks.

Key words: Islamic finance, Risk management, Risk Sharing, Guarantee, Risk transfer.

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1) Introduction:

The Islamic financial system consists of three main sections: exchange agreements, partnership agreements and charitable agreements. Fixed-Returns Modes exchange agreements are considered as a part of guarantee contracts that are based on sales with a known rate of return. As for partnership agreements, they are built on complementarity and cooperation between capital and work in order to create new wealth through joint investments, and are based on reliability and mutual trust of partners. It is for this reason that the parties to such contracts participate in profits and losses, that is, in receiving income and profits, as well as in assuming potential risks and losses. These two types of contracts are used today by Islamic banks. The third component is charitable agreements, which are usually the result of the joint will of donors who seek to do good to society through gift, alms, waqfs and other types of donations, as well as various types of charity. These are contracts that do not belong to the main activities of Islamic banks, since the latter are not charitable organizations, but only accept deposits and capital from depositors, investing them in exchange for agreed income in accordance with the formula agreed between the two parties.

These forms adopted in Islamic banks may vary depending on the presence of a guarantee in them or its absence. So some of them are considered guarantee contracts, in which each party is liable under the contract, as it is in the case with sale, lease and so on. Others are based on reliability and trust, as it is in the case with all forms of partnership, especially *murabaha*. In this distinction between these forms of financing Islamic law has taken into account the principles of fairness, interest and stability of financial relations in such a way as to guarantee the rights of all parties.[2]

2. Scope of the study and its hypotheses:

This article focuses on the subtle differences between the forms of Islamic finance used by Islamic banks. As for the hypotheses of the study, they are considered separately and fill a very important gap in this field of researches. These hypotheses are as follows:

– In what cases is one of the parties responsible for guaranteeing compensation?

– In what cases does neither party take any guarantees?

– What are the rules governing the provision of such guarantees?

– What is the relationship between the distribution of risks in Islamic finance?

3. Research methodology:

In the process of writing this article a descriptive approach is used, since in our opinion it is more consistent with the nature of the subject. In addition, analysis and comparison mechanisms are used as auxiliary tools.

Key research concepts:

a) The concept of "guarantee" in Islamic religious law (fiqh) is almost identical to its understanding in law science and generally means "compensation for a harmful act and the assumption of responsibility for actions". There are a number of definitions in the modern literature on Islamic law and we consider it appropriate and sufficient to highlight two of them. The first is the definition by Sheikh Mustafa az-Zarq according to which the guarantee is "The obligation to compensate for property damage caused to somebody".[3] As for the second definition, given by Dr. Wahba az-Zuhayli, it is "The obligation to compensate for property damage, lost profits or total or partial loss [of property] due to the human factor."[4]

b) Islamic finance: it is a financial system consisting of financial and investment activities in accordance with the normative prescriptions of Sharia, based on respect for the principles and foundations established by the Shariah for financial and economic

activities[5].This definition includes the vast majority of Islamic finance instruments, equally regardless of whether applied in banks and financial institutions or used by individuals in any society.

c) Guarantees in Islamic Finance Contracts. By these we mean explaining the existence of compensation guarantees in financing contracts in all their major varieties: exchange agreements, partnership agreements and charity agreements. And taking into account the fact that Islamic banks operate on the basis of commercial investment, charity continues to maintain its social (public) character and is carried out by charitable and non-profit organizations. As for Islamic banks, they focus on activities of a commercial nature, such as exchange transactions or investments, as in the case of *mudaraba*, *musharaka* and *muzar'a agreements*. These contracts may differ in terms of the presence or absence of guarantees. This is due to the fact that some of them are based on the fact that the contract is founded on trust or the party is liable only in case of abuse or negligence; while in others the participant is liable in any case. All this will be explained in detail below.

3. Principles of Islamic Finance

The origins of Islamic finance are rooted in the early history of Islam and it is a form of financing based on the principles of Islamic law dictated by the Noble Quran and the Sunnah of the Prophet Muhammad, peace and bless him, preserved in authoritative collections of hadith, and also these principles have been explained in detail by scholars in the field of Sharia in their legal interpretations of the teachings set forth in the Quran and Sunnah.[6]

Islamic finance is fundamentally different from traditional finance since according to the teachings of Islam the accrual and payment of interest is strictly prohibited. Given that Islamic finance is based on concepts such as ethical investment and ethical procurement they are governed by a set of rules and laws that determine how business and trade are conducted in economic system which is based on achieving justice for all stakeholders.

The most important principles governing Islamic finance are:

– Prohibition of accrual and payment of interest on loans (*riba*).

–Prohibition of concealment of certain aspects of the contract (such as the price, nature of the goods, its description or the time of its delivery) in agreement and trade relations, so that they are to be understandable to the contracting parties and fully documented.

– Sharing profits, losses and risks. This follows from the fact that Islam encourages partnership and social integration and at the same time does not seek to guarantee a fixed amount of income without participating in risks.

Prohibition of the accumulation of money and wealth. it aims to ensure the spread of economic development and the growth of wealth and its distribution in a way that benefits society as a whole.

Prohibition of unethical investment and trade, as it is forbidden to invest and deal with certain products or areas of the economy, such as alcoholic beverages, weapons, gambling, pork and suspicious financial transactions which is common for investments of the capitalist West.[7]

4. Islamic financial system

Although the legislative environment at the time of prophecy was simple and uncomplicated, and the systems of production and distribution were based on the logic of individual rather than institutional actions, the establishment of Sharia in the sphere of trade relations integrated the principles of general economic activity of that time. This activity included the agricultural, commercial and handicraft spheres, maybe in a simple and modest way, and in accordance with the primitive economic systems of that era. Most of the principles governing modern Islamic forms of finance are rooted in the subtle foundations that the Noble Quran established in general, and The Sunnah of the Prophet has already detailed in the form of normative prescriptions, specifying their content, and also indicating what is permissible and what is forbidden, even if their details and practical application may differ due to the difference in time and

development of life. Generally speaking, the most important forms of financing developed by Muslim jurists on the basis of Islamic primary sources can be divided into three parts: sales contracts with a certain share of profits, partnerships, and donations.[8]

4.1 Sales contracts with a known share of profits

The bottom of their line is that assets, goods and services of purchase and sale are the subject of the contract, regardless of whether the purchase and sale of the objects themselves or their benefits (usufruct) are carried out, since the income [profit] is fixed and precisely defined, and the fixed capital itself is guaranteed. As a definition of this concept we can say that this is the sale of assets and goods with a certain share (margin) of profit (Fixed-Returns Modes).

4.2 Partnership agreements (*musharaka*)

Their essence is that the subject of the contract is a partnership (either between such two elements as capital and work or a partnership only in capital or only in work) with participation in the expected profit or possible loss in the ratio agreed between the parties regardless of the idea of a fixed income and a guarantee of capital, except in cases of breach or default. It is noted that the operations of Islamic banks of this type are based on the fact that their financial structure [assets / liabilities] are based on the principle of profit and loss sharing, which excludes the idea of a fixed return on their investments, services and financing.

4.3 Agreements on charitable funding and donations

These are contracts based on the principle of giving up part of the wealth in favor of the weak in society (including poor, needy and insolvent) through almsgiving, waqfs and monitoring, as well as all aspects of financing based on the idea of solidarity, righteousness and charity aimed at achieving equitable development. The essence is that reimbursable exchange and partnership agreements should be based on the principle of justice, while donation contracts are based on the principles of charity, virtue and social solidarity, as well as on the

desire to eliminate or reduce the differences between the haves and the have-nots, to avoid the consequences of social explosions, economic and political wars, market cruelty and to ensure the protection of the weak from the powerful. Ultimately, it is this that makes charity complementary and perfect justice.[9]

The three above-mentioned components streamline all types of financing in Islamic law and integrate the various economic activities of any virtuous society. Their presence in any society is considered one of the most important factors in its economic stability and one of the best methods of ensuring the circulation and promotion of wealth within this community, as well as expanding the property base among the largest number of its members. This is especially achievable if mobility within society is balanced in its roles and efficiency, it is constant in size and distributed among the segments of the social system in such a way that its hierarchy in it realizes the goal of wealth circulation and the principle of equitable distribution.

5. Methods of financing in Islamic banks

Islamic banks use several financial instruments or formulas for their clients, and these formulas are intended for both individuals and organizations. These instruments have their own methods, conditions, controls and standards that must be regulated to ensure that they are Sharia-proof in Islamic financial transactions. Among the most important methods of financing most Islamic banks work with are the following:

a) *Murabaha* for a customer promising to redeem goods:

It is the process of a bank buying movable or immovable property with special characteristics based on the customer's request and promise to buy it, and then reselling that good to the customer at a profit after the bank becomes the owner and takes possession at a price that includes the value plus the profit margin that the customer promised the bank before the purchase.[10]

b) Renting:

This is an agreement between the bank and the client, according to which the bank leases property that is in the possession of the bank at the time of the conclusion of the contract, or has certain characteristics, which the lessor (bank) is obliged to provide to the client on a specific date. There are two types of rentals:[11]

– Leasing or lease with subsequent transfer of ownership "*Ijarah and Ijarah Muntahia Bittamleek*": this is when ownership of a leased property (such as a house or car) passes to the lessee at the end of the lease term after he has paid all lease payments equal to the price of the rented property.

– Operating lease: in which the leased property is returned to the lessor at the end of the lease term.

c) Custom manufacturing

This is one of the methods of direct financing by which a bank produces a certain product or builds a building at the request of its client, and it is defined as: "a contract of sale of the described property that needs to be manufactured." Custom manufacturing is a contract that is binding on both parties if it meets its terms, including an indication of the type of goods (to be manufactured or built) and their type, quantity, description, price information and determination of the time of their delivery. The banking application of the custom manufacturing method is achieved due to the fact that the bank (as a manufacturer) has concluded a contract with its client, acting as a customer, for goods that must be produced at a certain price within a certain period, then the bank has concluded an agreement as a customer with a specialized manufacturer / contractor for the production of goods with the same characteristics as the goods specified in the contract with the client. However, there is no connection between the two contracts. This is called "parallel custom manufacturing."

One of the distinctive features of a custom manufacturing contract is that it provides solutions for individuals to finance the construction of apartments and houses, provides solutions for companies and businessmen to finance their needs in the production of goods, and also offers solutions for financing the wages of the labor force, including industrial goods, as opposed to financing in the form of *murabaha*[12].

d) Sale of cars in installments

This is the formula by which a bank sells the cars at its disposal that belong to it and that it sells in installments to dealers. At the same time, customers are invited to purchase cars that are available in the parking lot and which the bank bought earlier, their receipt earlier by the bank gives a guarantee for them from the bank.

If the car that the client wishes to purchase is not available in the bank's parking lot, the bank acquires it and becomes its owner, and as a result of receiving it by the bank, the guarantee also passes and the car is offered to the client for purchase. This is due to the fact that the Islamic Sharia prohibits the sale of what a person (or bank) does not own, so the bank does not make a sale until it itself has received ownership of what the client wants to purchase, and does not offer him to see the goods and whether it corresponds to the description.

The sale to the buyer is not preceded by the signing of the promise to buy, and the buyer in both cases does not sign the promise to buy, and as a result, the buyer has no obligation before signing the contract of sale in installments.

e) Purchase with prepayment

It is a payment of the cost of the goods with a delay in their receipt, or a contract for something that has certain characteristics and is the obligation of the seller for the fee received at the time of the transaction. This is the exact opposite of other types of sales that require the availability of goods at the conclusion of the contract, and the sale with prepayment is considered an exception to this rule, but

provided that the quantity (volume) of the goods is known, it can be described by precise characteristics, and the date of its delivery is indicated in the contract, and the seller can transfer it to the buyer. The transfer of payment for the goods is one of the conditions for the sale with prepayment, so that there is no sale of the debt for the debt, which is prohibited by the Shariah. Islamic banks use prepaid sales in financing agriculture and financing the production of all goods that can be described by precise characteristics and transferred by the seller to the buyer.[13]

e) Partnership (*musharaka*)

The term "partnership financing" is based on the fact that an Islamic bank provides the financing requested by the client for a particular project, without specifying a fixed interest rate - as is the case with loans. At the same time, the bank shares with the client the ownership of the subject of partnership relations in proportion to the funds contributed by it, and the bank owns a certain percentage of the income of this project in proportion to its property rights.

A "diminishing partnership" which ends with the acquisition of ownership right is considered a form of partnership in which the client gradually replaces the bank in its ownership rights to the asset or project. At the same time, it does not matter whether this occurs as a result of a one-time payment or a gradual several payments, which occurs in accordance with the agreed conditions and is based on the bank's agreement with the client to participate in full or partial financing of the project with the expected income. As a result, the bank receives a proportional share of the net profit already received, and when the client pays out this financing to the bank he becomes the sole owner of the project.[14]

The share of both the bank and the client is determined in the form of shares or shares that have a certain value, and the amount of which represents the total value of the project or asset. At the same time, the client in each period of time can own a certain number of shares owned by the bank, so that the shares of the bank are reduced

by the amount on which the client's shares increase, until the client becomes the owner of all the shares and they become his full ownership. This form is most often used in Islamic banks.

g) *Mudaraba*

Mudaraba is the participation in profits on the basis that one party provides capital and the other (the manager in *mudaraba*) provides work. This form of contract complies with Sharia law and regulates investment cooperation between capital on the one hand and work on the other. Thus, the profit obtained as a result of the mudaraba procedure is joint and common between the two parties in accordance with the agreed shares. And if the losses of the project arise for a reason that is not related to the abuse or negligence of the manager, then the bank, as the owner of the money, loses its money, and the manager loses his efforts and his work, in accordance with the sharia rule, which states that participation in profits implies participation in losses.

There are two types of *Mudaraba*:[15]

- "Unlimited" *mudaraba*, where the owner of the capital delegates to the manager the right to manage operations without limiting him to any framework and he works with broad powers.

- "Restricted" *mudaraba*, where the owner of the capital restricts the scope of investment to a particular locality or sphere so that the manager works only in it or sets other restrictions that he deems appropriate.

7. Guarantees in Islamic Finance Contracts

Treaties in Islamic law are divided in terms of the guarantee of compensation for damage into four types:

1) Contracts originally legalized in the Sharia to guarantee compensation for damages, such as the surety agreement (*'akd al-kafala*) in the Hanafi religious-legal school, while representatives of other religious and legal schools call it a "guarantee contract" (*'akd ad-daman*).

2) Contracts which have been established by the Shariah not to guarantee compensation for damage, but to secure property rights, profits, and so on, at the same time they entail such a guarantee as a result or as a consequence of their normative prescriptions. This always takes into account the consignee, who in all cases is considered responsible for the goods or the pledged thing, for example, as is the case in contracts of sale, loan and the like.

3) Treaties characterized by trust. Sometimes it is implied that they are also aimed at making a profit, and are called "contracts based on trust" (*'ukud al-amána*), then the money received is in trust management in the hands of the recipient, who is financially responsible for them only in cases of negligence. For example, it can be a contract of trust for storage, a contract of provision for gratuitous use, *mudaraba* or *musharaka*, agency agreement and so on.

4) Bilateral contracts, as a result of which on the one hand there is a guarantee of compensation for damage, and on the other hand there is trust, for example, it is a lease or pledge agreement. Thus, under a lease agreement, the property is transferred to the tenant on the basis of trust, and the benefit of the lease is already the responsibility of the tenant. Accordingly, if he did not use the property he rented during the lease period, that benefit was lost by him at his own expense, and he is obliged to pay the rent, which is the value of the benefit (usufruct) of the lease[16].

If we go back to the three sections of Islamic finance that we have described in detail earlier, we find that reimbursable exchange transactions are based on a guarantee of compensation for damages, and the seller or buyer is financially responsible here. Thus, the payment for the goods is in the hands of the buyer, and it remains at the buyer's guarantee until it is transferred to the seller, since the seller has not yet received it and receipt is a condition for taking ownership. And the goods agreed by both parties, if it dies before it is delivered to the buyer, is under the seller's guarantee (liability), since ownership of it does not pass to the buyer until the latter receives it.

By analogy with this, we can say about all transactions of reimbursable exchange - the responsibility (guarantees) lies with the first owner, until the subject of the exchange (goods and payment for it) is received by the second party.

In Islamic banks hire purchase, *murabaha*, *Ijarah*, prepayment sales and custom manufacturing are considered guarantee contracts. Therefore, if the bank sells goods to a customer who has already transferred the value of the goods (as an advance payment) or promised to deliver the goods at a later time but the goods died before they were delivered to this buyer, in this case the responsibility lies with the bank. This is because the bank is the guarantor (is financially responsible) for the goods, therefore, the loss falls on him, and not on the client, since the latter did not receive the goods, and consequently did not take ownership of the goods, that's why the losses fell on the bank, and not on him.

This rule was adopted by all Islamic banks, which in this way relied on the unanimous opinion of experts in Islamic law. This rule became even more formal after it was adopted in the "Sharia Standards" of AAOIFI[17], for example, Standard No. 8 "*Murabaha*" (paragraph 2.5.2) states: "It is not allowed to impose on the client - the final buyer - the obligation to provide a guarantee of compensation for damage to the institution, arising from the total or partial destruction of the delivered goods at the time of their transportation or storage ... , the obligation to cover which lies with the owner of the goods."[18]

Indeed, we find similar references in all standards relating to reimbursable exchange contracts, which state that the contracting parties have no guarantee of compensation for damages until the ownership of the subject matter of the contract has been confirmed by the receipt [of the goods or payment for them] by the other party.

As for "contracts based on trust" – such as *mudaraba*, *musharaka*, *muzara'a* and so on, they are based on such an element as risk and the sharing of profits and losses by the parties, according to the rule "*al-Kharaj bi-d-daman*"[19] – "The benefit goes to the one who reimburses", that is, the profit is assumed only if the responsibility is assumed. Thus, after the owner of the capital has transferred it to the employee (the manager in the *mudaraba* contract), both parties are considered partners in the results of this contract. And if a profit is made from the investment, both parties divide it among themselves in accordance with pre-agreed shares. If the investment has led to losses, then the parties also participate in the sharing of this damage - the owner of the capital incurs losses in the form of his capital, and the employee loses the effort and time spent. The Andalusian scholar of Islamic law, Abu al-Walid Ibn Rushd, says the following about it: "And [experts in Islamic law] have reached a consensus that one person gives another his property on the condition that he will engage in trade for a certain share, which he will receive from profits ... And that the employee is not liable for damage [caused] to capital, unless there has been abuse on his part. And if that has happened, there are differences of opinion among them as to what can be considered abuse and what is not."[20]

Sharia established the general principle of this type of commercial relationship which is based on respect for the principle of justice and the inadmissibility of injustice and misappropriation of other people's property. Thus, the Noble Quran says: "**Oh, those who have believed! Do not devour your property among yourself illegally, but only by trading by mutual consent.**" [21]

We find that this is evident in the activities of Islamic banks, since this type of contract, based on the trust of the parties, applies the principle of sharing the risks and damages. An example of this is Standard No. 13 of *mud'araba* (paragraph 4.4) states: "*Mud'araba* refers to contracts based on trust (*'ukud al-amana*). Therefore, the manager is a trustee in respect of the capital provided to him under the

trust management agreement and is not liable, except in cases where he violates the terms of the contract ... and then he is responsible for the capital."[22]

We find that this rule is common to all standards relating to partnership agreements, but here it should be emphasized that Islamic banks, taking into account the increased degree of risks in these activities, take great precautions before entering into such transactions. In this regard, partnership agreements of various types in comparison with reimbursable exchange agreements are only 5%, while the profit from murabaha transactions and sales with deferred payment averages more than 60%.[23]"

In this regard, Islamic banks have come to the possibility of applying another tool in this area, offering owners of capital and deposits to transfer their finances to Islamic banks for investment in the form of *mudaraba*. In this situation, they will act as owners of capital, and the Islamic bank as a manager in the contract *mudaraba* and, having received these funds, the bank will invest them in such areas as sales under *murabaha contracts*, *Ijarah*, sale with deferred payment and the like. In such cases, the mechanism of opening investment accounts operating on the principle of unlimited *mudaraba* is most often used.

This is where the flexibility and fairness of the indemnification principle in Islamic law are evident, since such characteristics as "trust in reimbursable exchange transactions", "distribution of profits in loss contracts" as the most important incentive for maintaining trust and responsibility become apparent. In addition, these characteristics contribute to social integration, combining money with the element of work for new material values (wealth) creation in such a way that the degree of risk in such contracts is carefully calculated taking into account the nature of each type of contract.

As for charity contracts, in the vast majority of cases they are obligations of individual members of society and individual public institutions and are implemented through the payment of zakat, almsgiving, waqf and other forms of charitable activities. It does not matter whether this occurs in the form of individual efforts of individual people, or through organized forms of mutual assistance in the form of waqf foundations and institutionalized donations, as charities and third sector institutions do, even given their weak role in the Islamic world. In Islamic banks, there are charitable funds intended for zakat and other financial resources that are decided by the Shariah committees to be illegally treated by the Shariah Councils, as well as funds left by their owners. Money from such funds, under the control of the bank's Shariah Committee, are spent on the poor, needy and in difficult situations in order to ensure that they reach the real recipients. So that the bank in this role and bank financing based on equity meet social finance based on charity, the needs of society and the achievement of its well-being and order. In this role, the bank accepts bank financing based on equity, combined with social finance based on the principles of charity and aimed at meeting the needs of society and achieving its well-being and order.[24]

8. Conclusion and results of the study:

In conclusion of this article, the following findings can be drawn:

1) Islamic financing instruments are characterized by the inclusion of all activities in the field of finance and business in them, allow for the implementation of justice due to their ethics, honesty, diversity and absence in them of exploiting or oppressing the weaker party.

2) The sharing of reimbursable exchange contracts is based on guarantee, since it is characterized by such a quality as objectivity, which is closely related to the concept of law, as established by experts in Islamic law. This is explained by the fact that the subject of the transaction - until it is transferred to the second party - is under the guarantee of its first owner, since material liability is inseparable from the implementation and ownership right, which arises only as a result of the receipt by this second party.

3) The sharing of partnership agreements is based on trust, since such contracts are based on the element of risk when investing in order to make a profit. It's a complicated process that requires giving the manager in the contract of the *mudarib* or partner a certain freedom and space to speculate or participate so that he can expand range of his activities for the sake of successful investment and profit. And if this profit was received, it is divided between him and the owner of the capital in accordance with the ratio agreed upon at the conclusion of the contract. If the investment turned out to be unprofitable, then the losses are distributed between the parties: the owner of the capital bears property damage, and the manager wasted his efforts and time.

4) The reliance of contracts based on trust and reparations has led to stability and fairness in commercial relations on the one hand. On the other hand, the exclusion of liability in such contracts has led to the achievement of social integration based on the principle of sharing privileges, benefits and risks, as well as the protection each of the two parties to the contract from the risk or damage of only one of them. This is what was clearly manifested in the operations of Islamic banks, as well as in the texts of the AAOIFI sharia standards.

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[1] These terms will be explained later in the paper.

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