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Contractual Risk Transfer in Islamic Home Financing: Analysis in Bank Malaysia

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Abstract

Risk management has implications on pricing, governance arrangements, business practices and strategy. Nowadays, home financing contract offers more in the risk transfer form to increase bank profit. This is parallel with Islamic jurisprudence method *al-Kharaj bi al-thaman* (gain accompanies liability for loss) and *al-ghurm bil ghunm* (gain is justified with risk) that determine the matching between risk transfer and returns. Malaysian financing trends is to buy house. Besides, exists transparency lacking risk transfer issues to the clients because of not been informed clearly. Terms and conditions of each financing also does not reflect clearly that the risk has been transferred to the client, justifying a determination price been made. The assumption on risk occurence is also inaccurate as each risk is different with the type of financing contract. This makes the Islamic Financial Services Act 2013 in providing standards that transparent and consistent can be used by Islamic financial institution less effective. This study examines how far the level of the risk and obligation incurred by bank and client under various Islamic home financing contract. This research is qualitative by using two methods, document analysis and semi-stuctured interviews. Document analysis from literature review to identify profile, themes and risk transfer element in home financing from Islamic jurisprudence perspective. This study finds that need to create a risk transfer parameter by banks which are consistent with risk transfer theory according to Islamic jurisprudence. This study has potential to assist the authority in Islamic fnance such as The Central Bank of Malaysia (Bank Negara Malaysia) in regulating Islamic banking industry so that the risk transfer valuation in home financing contract based on home financing good practice and determined risk limits.

Keywords: Risk Transfer, Home Financing Contract, Sharia Compliant, Malaysia

Introduction

Risk management has implications on pricing, governance arrangements, business practices and strategies. Home financing contract offered today is more in risks transfer form to increase bank profit. This is captured with *kaedah fiqh* (Islamic legal maxim) of *al-ghurm bil ghunm* (no risk no return) that determine equivalent between risks transfer and return. Malaysian trend for financing is to buy a house. However, Bank Negara Malaysia (2014) finds that 26% of user not fully understand about the risks on a product. Besides, there are issues of transparency of bank risk transfer to customer for not being informed in detail. The terms and conditions in every financing contract also not reflect clearly what kind of risk has been transferred to the customers to justified pricing was made. If applicable the risk also inaccurate as each risk is different with the type of financing contract. This making the Islamic Financial Services Act 2013 (IFSA) in providing a transparent standard and uniformity can be used by Islamic financial institution is less effective. A specific study on this model should be carried out to formulate transparent risks transfer parameter, uniformity, acceptable to all parties and in line with *maqasid syariah* (objectives of Sharia). This study examines how far the level of risks transfer and obligation borne by banks and customers under various Islamic home financing contract such as *Bai' Bithaman Ajil* (deferred payment sale)*, Tawarruq* (To Buy On Credit And Sell At Spot Value)*, Musaharakah Mutanaqisah* (Diminishing Partnership)*, Ijarah Mawsufah Fi Zimmah* (Forward Lease) and *Ijarah Muntahia Bi Tamleek* (Lease Followed by Sale).

This study is a qualitative by using two methods namely document analysis and semi-structure interview. Document analysis from literature review will identify the profile, main theme and risks transfer element in the home financing according to *fiqh* (Islamic Jurisprudence) perspective. Meanwhile, home financing sheet product will be analysed to identify the profile, main theme and risks transfer element that exist in every home financing product according to the Sharia and banking expert. Next, data from interviews with Sharia and industry experts will be analyzed to evaluate the profile aspect according to industry, planning method, product design, monitoring, amendment action and continuous improvement. All the three data from the literature review, product sheet documents and interview transcripts will be analyzed by using comparative method based on home financing risk profile according to the type of contracts, bank institutions that offering financing and risk level financing by dividing into three scales namely low, medium and high. Furthermore, data analysis will identify what is the method of planning, product design, monitoring method, corrective action and continuous improvement action in line with the Islamic Financial Services Act 2013 and Islamic Banking Capital Adequacy Framework 2012. The finding of this study will provide information about risks transfer parameter by banking side in line with risks transfer theory according to *fiqh* (Islamic jurisprudence) perspective, *al-ghurm bil ghunm* (no risk no return).

This study is expected to build a particular Sharia parameter related to the risks transfer in Islamic home financing contract. This study has the potential to assist autonomous party in Islamic financial namely Bank Negara Malaysia in regulating Islamic banking industry to evaluate the risks transfer in home financing contract based on good practice of home financing and determined risks limit.

Literature Review

Risk is defined as a matter related with undesirable or unexpected result, uncertainties maybe seen from positive and negative aspects. Risk also linked to uncertain future events likely affect an achievement of a bank goal including the strategic objective, operation, financial and compliance (Ismail et al., 2015).

Risk in Arabic language called as *mukhatir* (bold) or *mukhatarah* (hazard) or *khatr* (risk). *Khatr* (risk) according to the views of scholar, from the grammar definition stated that risk is prone to damages and peril or close to perish (Ibn Manzur, 1990). But according to the majority of scholars, *khatr* (risk) has various meaning such as gambling (*maysir*), uncertainty (*gharar*) or compensation (Al-Alawanah, 2009).

The concept of risk in Islamic banking and finance can be understood when view from two dimensions: (1) Prohibition of *gharar* (Uncertainty); and (2) Contractual freedom. Discussions on operational risk in Islamic banks are important and becoming more complicated comparing to conventional banking because of the contract unique features and general legal practice. Although, the principal core of Base II as the basis of banking supervision is effective equally well connected and suitable ideal with Islamic banking institutions, risk management and risk management practice still require specific adaption to the Islamic bank's operational features (Abdullah et. al., 2011).

The theory of risks borne from the aspect of Islamic finance is refer as *al-ghurm bil ghunm* (no risk no return) (Al-Zarqa, 1989). Discussions about types of risk in finance have been widely studied such as (Selma, 2014; Imran, 2014; Yusri et al., 2013; Tariqullah et al., 2001; Rosly, 1999).

Saiful Azhar Rosly is among the earliest study the risks in BBA financing by stating the profit that generated from BBA sales is legal in Sharia laws as it comes from trading and not debt activities. Profit in trading is permitted as they do not run from risks, losses and uncertainties. Even the profit has been set in trading, the real profit remains random and uncertain (Rosly, 1999).

Risks also been categorized according to the risk's prohibition, significant risks and acceptable risks that can be avoided, half of them non-transferable and some of them can be minimized. Therefore, the structure of risk protection is based on different classification but interconnected with one another (Agha et al., 2015).

Besides, Megginson (1997) has interpreted risk as a high potential loss. Risk also been studied and identified as one of subjects in science social that including statistic, economy, financial management and insurance. Risk research in every field of science based on different aspects that differ from one another. The purpose of the risk study is to obtain some controls on the risks and manage them in a way that can reduce the bad impact of decision making (Hidrus et al., 2013).

Research to identify the measure and credit risks management, risks liquidity, risks market and operational risks of Islamic banks in Middle East and North Africa find that there are various methods that can be taken by Islamic banking institutions according to financing types. (Selma, 2014) This shows that effective of risk management is so important to strengthen the strength of capital is beneficial to all parties (Minhas, 2014).

Khan and Ahmed (2001), stated that credit risks is a risk when partners failed to fulfill the obligation on time and fully in accordance with the agreed terms.

Management of risk liquidity is very important till there is a liquidity management framework within Basel 3. However, the existing of liquidity framework is only devoted to conventional banking. Meanwhile, Islamic banking that offers different products and services as well as contracts require different approaches (Husaini et al., 2013).

Banks also able to use more innovative methods in forming more effective tools to manage credit risk. Next, study shifts to the efficiency of banks by looking at how it can influence banks management and credit risk itself (Hidrus et al., 2013).

The risk management as stated in Islamic Financial Services Act (IFSA 2013, page. 24) defines "risks to financial stability" has the same meaning in section 29, Central Bank of Malaysia Act 2009. However, the "systemic risk" type is more equal to the meaning of this study: "systemic risk" related to the designated payment system, means-

(a) The risk that is failure of participant and operator to fulfil the obligation payment or settlement will cause other participant incapable to fulfil the obligation payment or settlement when been asked to pay; or

(b) The risk that is failure of participant and operator to fulfil the obligation payment or settlement may cause significant liquidity or credit problem may be threating the stability of the financial system (Malaysia Laws, 2013).

The differences in analyze the efficiency and Islamic bank profit in Arab countries been made by (Molyneux and Iqbal, 2005). In the study, they found that when the cost of inefficiency is same, the inefficiency profit will vary.

Risks sharing also been described by Tareq and Hassan (2011) as prohibiting acceptance and benefit payment activities but is supported by other principles of Islamic teaching that supporting the risks sharing, individual and obligation rights, property rights and transparent contracts.

Innovation in financing products sees the boldness of banks taking risks. (Md Talib et al., 2008) expressing the latest development in new home financing.

Mohamad et al (2010) finds that risk factor completely gives a significant impact to Islamic banking performance in Malaysia during study period. This condition because of the Islamic banking in Malaysia is not only expose to the form of risks faced by conventional banking but also expose to the other unique form of risks that arise along with restructuring process of Islamic financial products.

Risks also often translated through partnership as bank is also involved as a social responsibility. According to (Sidawi & Meeran, 2011). This is because Islamic finance is formed through the concept of brotherhood and unity. All banking participants are considered as mutual risks taking and profit.

Credit risk management practice and relationship with effectiveness impact in banking institutions and Malaysia finance suggests that bank institutions should use more innovative methods in managing credit risks (Yusri and Aisyah, 2013). Furthermore, the comparison between risk liquidity in deposits and *Mudharabah* (sharing the profit and loss with venture capital) investment accounts can manage the risks liquidity in the banking sector. Therefore, proposals are made so that Islamic banking can use different approaches (Hashimah et al., 2013).

Conceptually, risks transfer mean removing any risk of offenses or credit, early termination risk of a contract, risks on asset such as damages caused by bank to customers that can reduce the effects and responsibilities.

Based on previous highlighted research, research on risks focused on clarification of risk types, measurement methods, risk effects and method of improving risk management by financial institutions. However, study on risks transfer parameter Islamic financing contracts has been not yet undertaken meanwhile Islamic home financing contracts are growing and attracted by the industry. The requirement to ensure transparency and uniformity of risks transfer will increase the effectiveness of Islamic Financial Services Act (2013) achievement and Islamic banking Capital Adequacy Framework 2012 that been used by Islamic financial institutions with more effectively.

Methodology

Description

Design Study

This study is a qualitative using three approaches that analyze literature review, documents on home financing product sheets and transcripts from semi-structured interview with Sharia and banks experts.

Collecting Data and Sampling Method

This study uses three methods to collect data namely source from literature review, document analysis from financing product sheets provided by banks and semi-structured interview method with Sharia experts and Islamic banking. Estimated 17 Islamic banking offering home financing and 17 Sharia panels or Sharia advisors in each bank used as interview sample to obtain data on profile by industry, planning method, product design, monitoring, corrective action, and continuous improvement.

Data ANALYSIS

Data analysis from literature review identify the profile, main theme and risks transfer element in home financing from *fiqh* (Islamic jurisprudence) perspective.

Document analysis on home financing sheet products to identify the profile, main theme, risks transfer element in home financing from industry practitioner perspective.

Data from interviews with Sharia and industry experts will be analyzed to evaluate profile aspects according to industry, planning methods, product design, monitoring, corrective action, and continuous improvement.

In addition to literature review data, product sheet documents, interview transcripts will be analyzed by using comparative method based on home financing risks profile according to the contract types, bank institutions that offers financing, financing risks level with three scales namely low, medium, and high. Finally, data analysis is expected to identify what is the planning method, product design, monitoring method, corrective action, continuous improvement by banking parties with risks transfer theory following the method of *fiqh* (Islamic jurisprudence), *al-ghurm bil ghunm* (no risk no return). All data that have been analyzed will be designed as a complete parameter of risks transfer in home financing products.

Discussion of Findings

Risk according to the 4th edition of Dewan Bahasa dan Pustaka dictionary is loss and jeopardy (Pusat Rujukan Persuratan Melayu, prpm.dbp.gov.my). In arabic language, risk from the word *khatar* which also means loss and danger (Immarah, 2009). Therefore, risk is refers to placing a condition that is harming human generally such as danger to misfortune, catastrophe, pain and others or even more specific to transaction that refer to business or loss suffered in investment. Thus, risk is a something in negative form in human life.

Profit in arabic language called *al-Ribh* which means additional revenue from business outcome and any efforts are done (Al-Jumuʹah, 2000). From the perspective of the term means an increase in capital from property exchange from one situation to another through an activity such as sale and purchase (Al-Jumuʹah, 2000). Hence, profit refers to additional revenue or gain on excess amount of capital and expenditure, acquired through certain activities based on goods exchange (*al-Tabadul* and *al-Mua^cawadah*), services or assets such as business, investment and others (Ab Rahim, 2012).

Islam recognises profit not only on capital whether in money, product as well as effort or services provided to gain wages (*ujrah*). Thus, the profits that excessive from capital including wage charge as in the 19th century, employment related services are growing rapidly. Therefore, understanding capital is not only involving products but also including business or cultivated land. This is has been explained by economist that productivity elements involve land, capital and business (Martan, 1996).

Risk is seen as a negative matter that against with profit target. So, risk for capital in form of machine tools is machine damage. Risk on land seen on fertility and width in an activity done whether for development, agriculture, planting and others. Similarly with services, the risk involved is human effort that tired and exhausted. Consequently, besides capital refers to the three elements of the above productivity that become expenses, so exist another past cost as additional expenses to reduce existing risks. Therefore, the past cost is expense exposures to cope with future risks so that existing risks will not occur to cause a loss.

In Islam, entitlement to profit is based on existing risks to undertake risks by the contracting parties. This is mentioned by Prophet Muhammad SAW in several *Hadith* (Prophetic Tradition), one of them is:

"No risk no return"

And also Hadith (Prophetic Tradition) (Abu Dawud no. 3508)

> *"(To gain) profit (investment outcome) must be confront at risk (and the guarantee of sold goods is safe-means no profit is promised."*

Activities that involving productivity to gain certain profit must confront with existing risks. Thus, bigger targeted profit is greater risks going to face. If succeed manage the risks will outcome targeted profit. In sale and purchase transaction, offer activities must fulfil user's demand. If the offer does not comply with the demand, then there will be a loss on the dealer side. Likewise, if the offer given more than the request will cause surplus. But if demand more than current offer may cause the price rising. This is the basis of risk overview that need to be dealt on how to maximize production to fulfil the demand so that users have enough supply. And this one of the wisdoms of buying and selling that does not only to maximize the profit only and to fulfil the needs of society (Al-Jarjawi, 2007)

Therefore, each of false transaction is not allowed by Islam even though it is agreed by both parties as it is risky either on one side or both or affects to the public generally. Thus, false transaction such as *riba* (usury) element still banned even if both parties agreed.

In addition to, Islam allows *khiyar* (option) to ensure there is no delayed risk on one side either on buyer or seller. The most important keyword in business is the will of both parties. This is because the requirement for party made an offer and demand will be fulfilled in state of willing. Therefore, the Prophet Muhammad SAW prohibited sellers selling unwanted by buyers such as fruit turn into wet without a buyer knows about it. But if the buyer knew about it and he neglected it then it is permissible (Al-Khin, et. al., 2008)

Profit that allowed in Islam refer to the effort in facing risks whether risks in the form of effort or capital owner. A profit without facing risks will cause human transferring on other side and at once it is a form of tyranny. Hence, the practice of *riba* (usury) is a form of oppression and tyranny as the additional that imposed on the loan is a risk transfer to the debtor. The result, the profit to be achieved without facing risks will produce a lazy society and hardworking. (Abd Rahman, 2010).

Ilahi (1984) stated that the process of 'multiplying' money is not accepted in Islam. So, the process of *riba* (usury) is a process 'multiplying' of the existing money. The additional gain from the *riba* (usury) is not through the productivity process. So that been called as 'multiplying' not 'producing' because of the extra free solely. Despite of in loan usury, creditors facing risk like an amount of lent money cannot be worked on it due to debt as well as the probability of the debtor will not pay the debt, but this is the reason for transferring the risk to the creditor by requiring multiply the debt. In fact, Islam has guaranteed the amount of the debt owned by the debtor without any deduction. And the basis of the loan contract is faith means welfare so of cause the amount of the given debt is the purpose of helping instead of profit oriented.

Abd Rahman (2010) stated that the banned risks in Islam because of the following factors
1. Small success compared to failure and loss. For example, gambling activities.
2. No something to seek out but something intentionally to add value to an asset as purchase item or investment. For example, intentional risk is speculative activity.

The above risk is forbidden because of it against with the *maqasid shariah* (the objectives of Sharia) for the purpose of bringing justice and rejecting harm. This risk will bring harmful to those either who do the business on their own or transfer the risk to those who are not supposed to. Because of that, all activities which possibility greater losses such as gambling then it is forbidden. Same goes to *riba* (usury) that burdening the debtor with multiply to the debt requested.

The allowed risk is risk that cannot be disposed of transfer in a transaction. Otherwise, it would disgrace the justice to the involved parties. Therefore, in *qard* (loan) contract, it is not permissible a property with something additional imposed on debtor as the act is risks transfer that borne by creditor to the debtor. As well as in *wadi^{c}ah* (deposit) contract that giving trust to a party to protect the goods. So, it must not transfer the risk to the keeper to borne the losses of the goods if the losses due to his action or negligence. Therefore, the act of damaging the goods or negligence is the future risk to the owner of the goods, making the borne risk on the guilty party in this case to eliminate future risks on the owner of the goods.

Conclusion

Risk is common in a transaction to qualify the contracting party to gain the targeted profit. Wrong risk management causing oppression in the transaction so denying the wisdom of buying and selling in the context to fulfil the needs of the society. However, risks are existed in any contract as it has relevance in supply and demand.

The difference in conventional financial loan is the risks are transferred to the other party only in the interest of other party advantage. Thus, conventional financial practices *riba* (usury) such as interest rate on requested loan. Indirectly, it increases the existing burden on the debtor. The interest rate is an indictment to eliminate the creditor risks who has "froze" their rights by lending to the requesting party. Same goes to fixed value profit in investment concept which also can be called as interest rate. So, the fixed determination and definite is a big risk on investor in sharing the mutual profit as each transaction are at risk of loss. Thus, Islamic finance in *al-Mudarabah* (Islamic investment) contract introduces profit-sharing concept (PLR) based on a percentage breakdown in a distribution. PLR counting is more flexible in reducing risks on capital owner especially in time of profit does not reach the target as well as in the condition of loss. Hence, this is the most appropriate calculation in bringing justice to the country economy system to some of the transaction that practicing interest rate calculation. (Hasan, et al., 2005).

When in the matter of conflict between two parties in the sell and purchase contract then Islam provides solution by eliminating the future risks like *khiyar* (option). Therefore, the *khiyar* (option) of purchase that has damages eliminating the future risks that occur on buyer. As well as, when happen capital owner claiming with entrepreneurs on the determination of profit-sharing in the *al-Mudarabah* (Islamic investment) contract.

In this respect, the authors welcome comments, feedback or suggestions from regulators, financial institutions and other Islamic finance practitioners on the proposed concept of risk which may benefit their respective institutions or the industry as a whole.

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