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Sharia Finance Managing Risks: The Case of Covid-19

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Abstract:

Purpose: *The purpose of our work is to analyze the efforts of the Islamic financial industry to deal with the COVID-19 crisis and highlights its support for conventional finance, and global economy.*
Design/Methodology/Approach: *Desk research and case studies were provided to identify type and scope of the legal and economic measures taken by the governance of Islamic finance meeting the challenges imposed by the Coronavirus pandemic and analyze how they match with the conventional finance proposed resolution.*
Findings: *The outcome of this article is the evaluation of main measures of the Islamic finance system according to their effectiveness and efficiency providing a case study of the COVID-19 crisis.*
Practical Implications: *The approach of the best practice to the global financial policy has been proposed. Global Islamic finance is largely concentrated in the Middle East, Asia and North Africa, where the Gulf Islamic finance markets hold a 40.3% share. The findings have been used to consider as the policy directives for the conventional finance system.*
Originality/Value: *The assessment of the impact of the measures taken by Islamic finance industry, in short and long-term as a results of the process of integration and harmonization to conventional finance.*

Keywords: *Global finance system, global economy, Sharia finance, COVID-19 crisis.*

JEL codes: *E02, E44, E58, E66.*

Paper type: *Research article.*

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1. Introduction

Islamic finance is still unrecognized market and unexploited potential despite its rapid development in the Gulf Cooperation Council countries, Southeast Asia (Malaysia, Indonesia), Africa and Western Europe. It is no longer a phenomenon dissociated from global finance but a real alternative that offers instruments and solutions to the lack of capital and faulty distribution of resources. Currently Sharia finance system is going through a transitional phase due to the disastrous impact of COVID -19 pandemic. A health crisis that has resulted in an economic one, in fact experts' diagnosis warns of a recession worse than the one experienced after 2008.

However, Sharia financial industry disposes on two main instruments to deal with the increasing risks threatening the stability of the market and the customers’ trust. First instrument is the efficient risk management which has developed an appropriate technical and regulatory framework to analyze and predict the likelihood of a possible crisis to overcome it. Second instrument stems from the social nature of Sharia financial instruments, which has been reinforced by extensive case law to manage the crises generated by pandemics and support the economy.

To what extent the legal and economic measures taken by the governance of Islamic finance meet the challenges imposed by the Coronavirus pandemic and how it matches with the conventional finance proposed resolution? This article trying to answer this question provides a case study that aims to analyze the efforts of the Islamic financial industry to deal with the COVID-19 crisis and highlights its support for conventional finance, and global economy.

2. Materials and Methods

2.1 Overview of Halal Finance

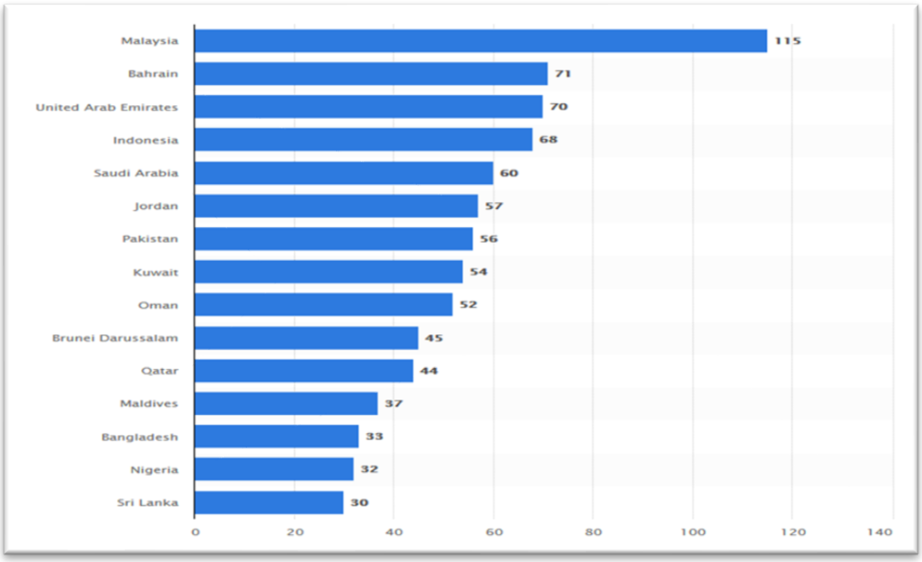
The *sharia* financing is a process based on indebtedness, partnership, and charitable acts so as donation, it is governed by regulation intended to achieve profits for parties in transaction (avoiding harm) and ensuring public interest (Al-’Umur, 2003). It is a financing model that confirms the validity of the currency as a medium and instrument of exchange having a determining role in the development of societies[3], (Al-Maqrizi, 1998).

A recent study showed that the total value of the assets of Islamic finance in the world reaches 2.43 trillion dollars, of which 1.72 trillion dollars are assets for Islamic banking. These assets are expected to rise by 56% to reach $ 3.8 trillion by 2023.

[3] *A Treatise on Islamic Coinage: The Shades of Contracts in Mention of Money, a manuscript by the author Taqi Din Ahmad al-Maqrizi dating back to the year 1018, preserved in the Library of the University of Riyadh, Department of Manuscripts under the registration of 13 BC.*

Global Islamic finance is largely concentrated in the Middle East, Asia and North Africa, a space where the Gulf Islamic finance markets hold a 40.3% share, while the rest of the Middle East and North Africa region holds a share of 38.6% of total assets. For Asia it accounts a share of 18.7%, Africa with a share of 0.8%, while the European, American and Australian markets control a share of 1.7% of the Total, markets control a share of 1.7% of the Total (Globe Mewswire Report).

Figure 1. *Islamic Finance Development Indicator value score of leading Islamic*



2.2 Axiological Rules in Sharia Finance

Legal provisions (*Sharia*) and specific rules for halal finance could be summarized as following: – Necessity of ownership, (*wujub al-tamaluk*), – Realism (the thing or good owned should allow hypothetically a certain growth because the profit of the owner depends of the growth of the good), – Financing must be orientated to the production of goods and services (real economy), – Prohibition of usury and interest due to factor time, – Avoiding hoarding money, – Profit and Loss Sharing based on a participatory logic, – Compliance of the projects with sharia, – finance profitability (Qahf, 1998).

In principle Islamic finance aspires to achieve fairness in distribution of transaction income sustaining the principle of profit and loss sharing proportionally determined according to the share of each party in investment or business (El-Melki, 2011). It also seeks to stabilize transactions by adopting an effective and strict risk management system associated to the main legal rules and procedures known in conventional finance to determine the business strategy and to face the foreseen and assumed risks as well, (Duran, 2012).

For the sake of clarification, it must be recalled that the Islamic finance system has ratified all international agreements organizing this sector (institutions, warranty, operational system, Staff), to be in harmony and integrate conventional financial global market, (Aglonby, 2009).

2.3 Main Sources of Risk in Sharia Finance

Experience proves a substantial matching and similarities in terms of measures managing risks between Islamic and conventional finance. It is a basic requirement for a unified legal organization to disarm *"Halal"* finance from the privileges and facilities which it is supposed to grant to client's capital as in *Musharaka and Qard Hassan* contracts. Despite that, Islamic banks face severe criticism because of the high level of risks due to association of different factors regarding management, guarentees for investors, Staff qualification, and other. Most traditional known risks that affect this system are the lack of adequate financial resources, investment expertise, support devices and systems, need of quick returns and liquidity to establish itself in the market (long-term investments do not achieve) (Alasrag, 2010) compulsory legislation regulating conventional banking, monetary policies approved by central banks (not commensurate with the specificities of Islamic banking), the prevailing social concepts confusing financial services with charitable acts, and ferrous competition from conventional finance (Qandur, 2012).

2.4 Risks Management Principles in Sharia Finance

All financial and banking literature overwhelmingly focuses on the issue of risk management and illustrate it principles, a strategy which represent the key driver that financial institutions and banks must observe to achieve effectiveness ensuring stability and profit (Iqbal, 2007).

Bank's Board of Directors assume primarily the responsibility for risk management, in confront of the shareholders to approve risk management strategy, that why each bank must create an independent "*Risk Management Committee*" including some of the bank's executives, to assume the responsibility for defining and setting risk management policies based on the risk management and the general strategies, settled by the board of directors (Fakhrunnas, 2017).

To strengthen coordination to face risks, a specialized department has to be established to undertake the implementation of risk management policies assuming a daily responsibility monitoring and measuring risks to ensure that the activities of the bank are carried out in accordance with the approved strategy (Hassan, 2015).

For the closure of these principles a risk officer is appointed for each of the main risks facing the bank, especially market, operational, credit and cash risks. All these measures must be accompanied by the creation of a specific system for measuring and controlling risks to determine its level and impact on the bank's profitability using an integrated set of limits as for credit limits, (Khan, 2003).

3. Results

3.1 Sharia Financial Industry Managing COVID- 19 Impact

The COVID 19 could be the worst global misfortune affecting financial industry after 2007 crisis. It is causing a systematic downturn of economy. Up to S&P Dow Jones Indices the outcome of the COVID-19 was felt in the global stock market losing $6 trillion in value between 23 and 28 February. The S&P 500 index fell by 28% from February 20 to March 19. The FTSE 250 index fell by 41.3%, and the Nikkei fell by 29%. Together, International banks suffered substantial loss in share price: JP Morgan Chase's share price fell by 38%, Barclays' share price fell by 52%, (Ozili, 2020). In these critical conditions Islamic financial industry is forced to develop an urgent and effective strategy to face this threat to save its growth and stability (Ries, 2020).

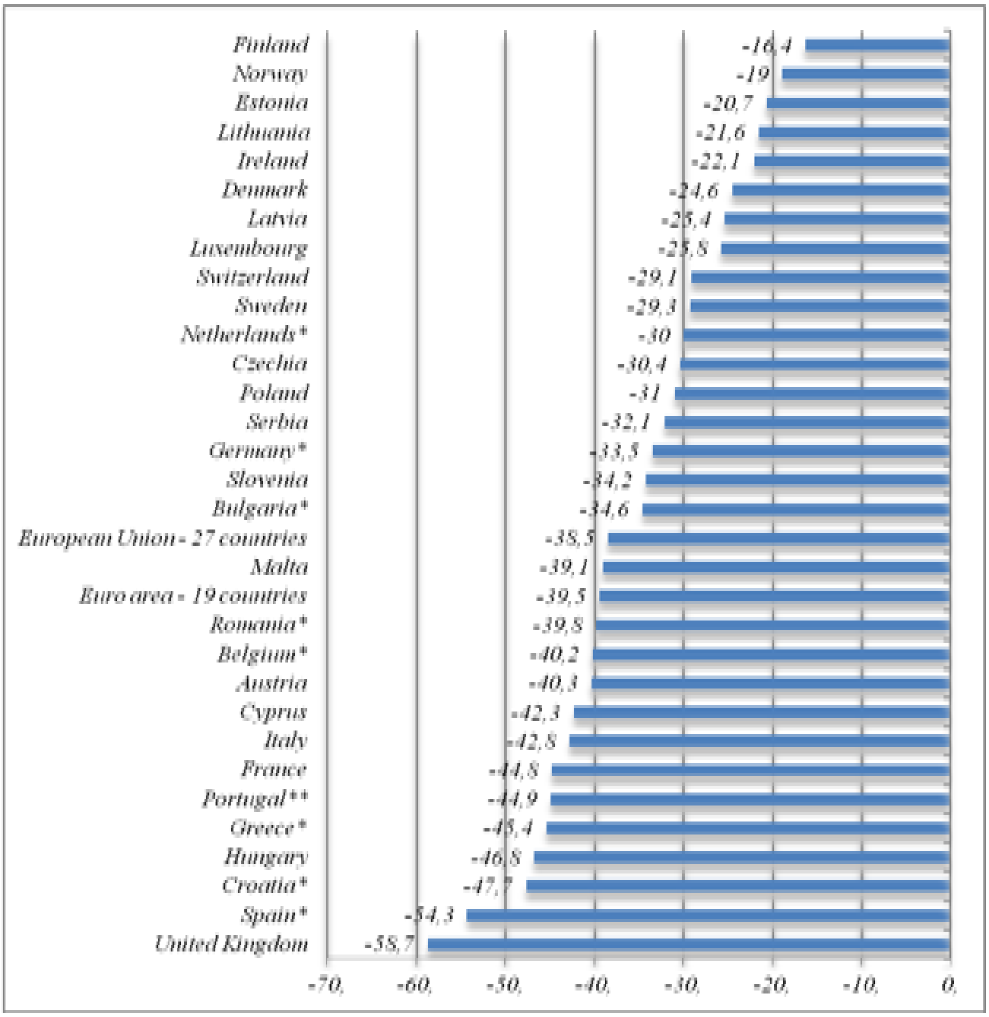
A strategy that must provide customers' needs for capital, considering the fall of deposits resulting from the lockdown of economic activities stopping production, distribution and dealing with banknotes (considered as contagion factor according to instructions of the World Health Organization). This system has to consider also that the use and the output of the digital technique for the banking and payment services remain limited for failure of the applications and the lack of practice (for individuals) in addition to the risks of piracy.

Effectively Islamic finance system as part of the global financial industry presented its vision to address the challenges posed by the Corona pandemic, especially after the General United Nations Secretary call for international solidarity to contribute to mitigating the effects of Covid 19. Islamic Finance presents its vision within three axes defined by the United Nations[4]:

- Addressing health emergencies;
- Focusing on social impact on response and recovery;
- Helping countries recover more sustainably in the long term.

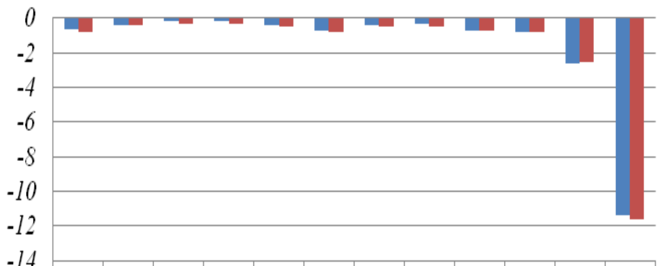
[4] *UN response comprehensive response to COVID 19, https://www.un.org/en/coronavirus/UN-response 25/06/20202.*

Figure 2. *Under the impact if COVID 19, European economies experienced severe challenges in Q2. Spanish, Croatia, Hungary and Greece economies performed the worst out in Q2. The opening after the first wave of COVID 19 was supposed to rebound its economies, however the only effect is the increase in infected populations.*



Note: *GDP and main components (output, expenditure and income - 2020 Q2* - provisional // ** - estimated*
Source: *ESTAT on 24/10/2020.*

Figure 3. *Quarterly non-financial accounts provide the general government with information on general government revenue totals (taxes, social contributions, capital transfers, etc.) and expenditures (employee compensation, intermediate depreciation, social benefits, interest payments, etc.). These data reflect the clear impact of Covid, especially during the first two halves of 2020. Quarterly non-financial accounts for general government 22/10/2020.*



	2017-Q3	2017-Q4	2018-Q1	2018-Q2	2018-Q3	2018-Q4	2019-Q1	2019-Q2	2019-Q3	2019-Q4	2020-Q1	2020-Q2
European Union - 27 countries	-0,6	-0,4	-0,2	-0,2	-0,4	-0,7	-0,4	-0,3	-0,7	-0,8	-2,6	-11,4
Euro area - 19 countries	-0,8	-0,4	-0,3	-0,3	-0,5	-0,8	-0,5	-0,5	-0,7	-0,8	-2,5	-11,6

Source: *ESTAT Data on 24/10/2020 .*

3.2 Sharia Jurisprudence Managing Pandemics and Emergencies

Basic rule in Sharia traditional jurisprudence impose to consider circumstances and evolution that affect people and companies during the exercise of their activities, during pandemic and emergency. From this standpoint, it is interesting to present solutions provided by jurists to confront epidemiological situations, as in the case of COVID-19.

Commitment to social responsibility: The origin of social responsibility is consolation focused on the human nature; therefore, it is one of fundamental element in the construction of Islamic social system. There are many legal texts in this sense, even if they are driven based on volunteerism and commitment. If there is a crisis, catastrophe, calamity, disaster, fatality, accident, disgrace, and its acquaintance require money, and if there is money in the public treasury (*Baytu a-mal*) this institution bears the cost, and if this institution has no money, all Muslims jointly bear the costs, (Al-Juaini, 2019).

Exemption or consideration of the debtor insolvency: The origin of this principle comes from the context of prohibiting debt interest: *"And if it is misfortune, then look at the ease"* (*Quran 2 – 280*); the interpretation of this verse means that exemption from debit depends on the will of the creditor, however, if the difficulties reach a level at which they will be detrimental, just as an epidemic case can occur, for debtors, then exemption from payment becomes compulsory. So, claiming a debt is an acquired right when the debtor possesses the ability to pay, but if the insolvency is proven, there is no way to claim this debt, (Ibnu and Rushd, 1988). Annulling the lease with excuses some jurists considered that the existence of an excuse that results in harm to one of the parties to the lease contract, permits the losing party to annul the contract.

Pandemic situation: It is a matter related to the occurrence of a natural disaster for agricultural products and the like, after the seller has sold them and before the buyer fulfills his obligation. This jurisprudential position has been linked to the theory of emergencies or contingencies for contemporary jurists.

Prevent excessive shopping: It is recommended to Muslims to be economical in consumption, in ordinary time or in order to overcome the crisis, *"And those who spent they did not spend and did not devote themselves to and between that was stewardship"*, [Quran 25/67].

3.3 Guidelines of Public Policy in Case of Pandemics and Emergencies

Pricing and antitrust: In normal circumstances, the state may not intervene to fix the prices nor force the trader to sell at a price he does not like. However, the jurists were aware that the issue was related to the public interest; Therefore, in extraordinary cases, they allowed the intervention of the responsible authorities to preserve the public interest, such as the case of the spread of an epidemic.

Taking into account contingencies in contractual obligations: Such as when the circumstances of the epidemic; do not allow the delivery of the sale in the specified date, or delaying the deductions in the forward sale without increasing the price, or making debts in the equivalent of gold, silver or similar goods for fear of changing the value of the local currency, (Al.- Nahyan 2013).

Tax Laws to Address the Covid-19 Crisis: They are temporary provisions, more effective, faster, and easier to repeal, rather than making amendments to existing laws or issuing new ones. Such dispositions are to save the integrity of the system and prevent from the risk of weakening tax certainty after the current crisis subsides, (Waerzeggers, 2020).

3.4 Solutions Related to Wealth Redistribution and Social Solidarity

"Al.-Qard al.-Hasan", Interest-free Loans: A financial relationship in which the debtor refunds only the sum of loans without any return; this financial instrument is permissible and recommended to maintain solidarity and brotherhood promoted in Islam.

*"As-Sadaqat", Charity***:** We can distinguish *"As.-Sadaqah"*, simple charity linked to the will of the individual who carries it out (when and how he wants); and *"As-*

Sadaqah al.-.wajibah", obligatory charity, a duty imposed on fortunes for the needy, is similar to Zakat in that it must be carried out.

"Az.-Zakat", Alms: Term referring to the obligation that an individual has to donate a certain proportion of wealth each year to purify earnings that are over and above what is required to provide the essential needs of a person or family (Some jurisprudence has permitted paying zakat in advance of its time due to the public interest) (*Ibnu Rushd)*[5].

"Al.-Waqf", Endowment: A permanent endowment of owned thing, that can be a building, land or even cash for charitable purposes with no intention of reclaiming the assets (Edaich, 2016).

3.5 Solutions Related to Financial Transactions

The strategy of Islamic financial industry cannot be considered separately from the policy of international financial instances in accordance with international treaties. Therefore, reference must be made to the most important policies that central banks and global financial institutions use to reduce the repercussions of the spread of the Corona pandemic. These policies can be summarized in the following measures:

- Lower interest rates;
- Long-term buybacks;
- Anti-Pandemic Bonds;
- Relief packages;
- Application postponed of Basel III standards.

In this regard and considering its mandate to regulate and supervise banks, the Basel Committee submitted its proposals to central bank governors for approval, especially regarding cash management (for Islamic banks). In coordination with their countries and their supervisory authorities, Islamic financial institutions must introduce the following issued directives to their system:

- not changing the rules: In a crisis, changing the rules causes confusion,
- not hiding losses: Banks and shareholders must bear the losses, transparency helps all parties recover quickly,

[5]*Ibnu Rushd: 1126 -1198, born in Cordova, Spain, he studied law and medicine. In 1169 (565 AH) he was appointed a judge in Sevilla; he also translated Aristotle's book de Anima (Of the Soul) during this year. In 1171 Ibnu Rushd was transferred to Cordova, where he held the position of a judge (Qaadi) for ten years. During that time, he wrote commentaries and interpretations on the works of Aristotle, among others on Metaphysics, and on Plato's Politeia. In 1182 (578 AH) he was called to Marrakesh to work as a physician for the Caliph there, but he was soon transferred back to Cordova with the title of Great Qaadi (Chief Judge).*

- organizational treatment of subsidy measures: To help increase transparency, clarifications must be provided in advance on how Islamic banks will handle measures, credit guarantees, and payment exemptions towards any suspension or suspension framework,
- promote communication and encourage continuous dialogue between observers and Islamic banks (Abdel Moneim, 2020).

3.6 Responsibility of Financial Institutions to Facilitate Charitable Acts

The function of financial institutions is to use the investors' capital in order to make a profit preserving funds, in Sharia, this duty is extended to sector of non-profit activities, such as the interest-free loan, charity and endowment. The root of this social responsibility is innate in human nature and stipulated in all beliefs, faith. and legal systems, (Shahrour, 1996])

4. Discussion and Recommendations

Covid-19 pandemic is causing enormous economic cost and losses, with a negative shock in demand and supply, and the collapse of oil prices. Given that, countries have taken a series of preventive measures to contain the outbreak of the disease. These measures unfortunately limit the movement of people, the transport of goods, and threaten the service sector. The impact of the Coronavirus outbreak may exacerbate regional differences, structural imbalances, and to political instability as well, (W. E. F, 2020). Simultaneously, the spread of Covid-19 led to a strong rise in the income of some industries, such as masks, disinfection, and sterilization materials. Also, a strong evolution can be observed in digital services (funds transfer, payment and others) that may lead to a radical transformation of human life.

The assessment of the impact of measures taken by Islamic finance industry, in short-term remain weak and at times insensitive. These provisions generally do not differ from those taken by conventional finance authorities, because of the process of integration and harmonization that begun with the birth of Islamic finance.

In the long term, the alternative to improve the digital finance is not enough built to match with the existential needs of most of the population around the World. The average of excluded from the virtual business is increasing because of the gap between the poor and the rich. Aid and assistance can never produce wealth. Coordinating the financial industry policies managing risks, between Islamic and conventional financial systems could be decisive defeating disastrous impact of COVID 19. Not only that, but it becomes possible to face other expected or unexpected crises reducing its impact on global finance and economy.

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