SHARED RISK & REWARD

Issue 111 – August 19, 2012

Risk-scattering in Islamic finance

Earlier this week, I wrote a blog post suggesting that Islamic banks might not be in the best position to use mudaraba and musharaka because it exposes depositors to greater risk than the non-risk sharing products. Instead, I suggested that products like mutual funds—where investors come with an acceptance that they may lose money—is a better venue for the profit-and-loss sharing structure.

After writing the post, I found a paper examining whether there were fundamental flaws in the modern application of risk-sharing products, and suggest that Islamic finance has strayed from the classical forms of mudaraba and musharaka in a way that shifts risk from those who are able to manage it to those who are not. The author, Shinsuke Nagaoka, writes:

"However, the economic wisdom of partnership contracts argued above has some usefulness in that it reminds us of the harmful aspects of the current trend in Islamic finance, which is now replicating securitized conventional finance."

Nagaoka suggests that products like sukuk al-mudaraba impose risk sharing on the parties, but also add a degree of risk scattering. Nagaoka argues that the risk scattering comes from broadening the number of investors who must engage in costly monitoring of their investment, which will "increase the extent of asymmetry of information in the system".

Nagaoka compares the risk-scattering effect of mudaraba and musharaka with conventional securitizations that caused the financial crisis, which is not entirely fair since there were many other factors that went into the financial crisis (e.g., re-securitizing securitized products and the use of derivatives to add leverage).

The idea of risk-scattering does have an impact on my argument about Islamic banks using mudaraba and musharaka. Islamic banks are sophisticated enough to manage risk efficiently on behalf of depositors, which limits risk-scattering. However, the use of mudaraba deposits will increase risk-scattering since depositors—most of whom are likely to be small—will have an insufficient ability to monitor the risk of the investments made with their deposits.

When depositors' expectations about full return of their deposits at any time is combined with their inability to effectively monitor bankers, I think that banking is not an ideal business to incorporate risk-sharing products on a large scale.

Until next week,
Blake Goud

My Reading List

- Should Islamic banks use mudaraba and musharka (Sharing Risk)
- Nagaoka: Reconsidering mudaraba contracts in Islamic finance (link)

Blog Posts This Week

- Should Islamic banks use mudaraba and musharaka?
- Accreditation of Shari'ah scholars is a big step forward
- Islamic finance enters Oman

SHARING RISK
1500 SW FIRST AVE., SUITE 910
PORTLAND, OR 97201

http://www.sharingrisk.org
@sharingrisk
Sharing Risk Blog