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A Risk Sharing Banking Model

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Abstract

Islamic Banking has thus far mimicked conventional banking with the result that the same problems and outcomes have surfaced, even though it is operating within an interest free framework. This apparent “convergence” has led to disaffection both among consumers of Islamic Banking services and policy makers. This paper proposes a risk sharing model for Islamic Banks that can potentially pull Islamic banking away from this path dependency. Under the proposal an Islamic bank’s assets would be securitized by the issuance of sukuk type instruments that have the same underlying contract and average “duration” as customer financing. Small assets may have to be pooled into tranches of similar maturity before being securitized. Medium and larger assets would have papers issued directly against them. Thus, instead of depositors, an Islamic bank would have thousands of sukuk holders, all of whom share the profits and losses arising from their respective tagged asset. Other than Wadiah based safe custody accounts and current accounts against which the bank holds cash, all other depositors would be “sold” sukuk for the amount, duration and risk level that they prefer. The model has several advantages such as, minimizing systemic risk through risk dissipation and reducing the liquidity mismatch inherent to banking. The securitized papers provide new liquidity instruments and can enhance liquidity within the Islamic finance sector. Where the macro economy is concerned, the proposal enhances system stability by reducing risk concentration within the banking system, substantially wideming financial inclusion by way of small denomination sukuk and minimizes the contingent liabilities of governments by avoiding the use of deposit insurance.