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Islamic Finance and COVID-19 Recovery: The Role Profit-Loss Sharing Contract
(*Kewangan Islam dan Pemulihan COVID-19: Peranan Kontrak Perkongsian Untung Rugi*)

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ABSTRACT

This note uncovers the beauty of Islamic finance via its Profit-Loss Sharing Contract (PLSC) as a financing tool in helping the economy and businesses to recover from COVID-19 economic crisis. PLSC is a contract that shares business risks between participants, while Interest-Based Contract (IBC) requires entrepreneurs to bear the entire business risks. Besides its fairness and justice in wealth creation and income distribution, past literature have shown that PLSC has been successfully adopted in various countries across industries. Redesign of mind-set and role from self-interest to common interest and from intermediaries to entrepreneurs are needed for the financial sector to embrace the benefits of PLSC towards achieving economic and societal sustainability.

Keywords: COVID-19 pandemic; Profit-loss sharing; Islamic finance; sharing risk

ABSTRAK

Kertas kerja ini merungkai keindahan konsep kewangan Islam melalui Kontrak Perkongsian Untung Rugi (PLSC) sebagai alat pembiayaan dalam membantu firma perniagaan untuk keluar dari kemelut krisis ekonomi akibat pandemik COVID-19. PLSC merupakan kontrak pembiayaan yang melibatkan perkongsian risiko perniagaan antara peserta, sementara Kontrak Berasaskan Faedah (IBC) menghendaki pengusaha menanggung keseluruhan risiko perniagaan. Selain terkenal dengan konsep adil dalam penciptaan kekayaan dan pengagihan pendapatan, literatur masa lalu menunjukkan bahawa PLSC telah berjaya diguna pakai di pelbagai negara dalam berbagai industri. Mereka-bentuk semula pemikiran sektor kewangan daripada konsep 'penting-diri' kepada kepentingan bersama di samping perubahan peranan daripada sebagai 'pengantara' kepada 'usahawan' amat diperlukan agar sektor kewangan dapat memanfaatkan kelebihan PLSC bagi mencapai tahap ekonomi dan sosial yang mapan.

Kata kunci: Pandemik COVID-19; perkongsian untung rugi; kewangan Islam; perkongsian risiko

EDITORIAL NOTE

The Coronavirus disease 2019 (COVID-19) pandemic has created a sudden change in every aspect of our lives (Nicomedes & Avila 2020). Despite the fact that many around the world are living in near-isolation, one important element of COVID-19 is that it brings everyone together in terms of the desire to help each other in some way, whether tiny or gigantic. Notwithstanding the positivity of teamwork and gold price performance resulted from COVID-19 outbreak, on the other side of the coin, it is a miserable fact that COVID-19 has rooted several mishaps. For examples, it causes thousands of death worldwide (World Health Organization 2020), on-going financial burden on all countries (Barbier & Burgess 2020; Edwards 2020; Sahoo & Ashwani 2020; Zou, Huo & Li 2020), decreasing economic confidence (Yang & Xin 2020), and increasing economic anxiety at individual level (Mann, Krueger, & Vohs 2020). The economic waves of COVID-19 especially in the emerging countries such as in the Pacific[1] are resulted from how the government policy reacts towards solving the unexpected health, psychological, and economic attack. Most governments cannot constantly afford the huge costs of the remedial policies due to reduction in the tax revenues. Furthermore, rising of the unemployment rate (due to closing businesses), tax exemption (to support the active businesses), direct payments to citizens who have lost their jobs, and heavy medical expenses somehow exacerbate the government financial impediment. Simultaneously, while most of those countries are integrated, the economic

costs of the local as well as intercontinental policy reactions towards COVID-19 have led an enormous economic suffering in the region. (Edwards 2020).

From the microeconomic view, firms' performance across sectors swung abruptly during the COVID-19 pandemic in which most firms have witnessed deteriorating profit (Fu & Shen 2020) and gone through tumbling stock returns (Narayan & Phan 2020), and struggled to payback monthly instalment financing (Bresser-Pereira 2020). Even though a few governments such as Malaysia and Iran offer a moratorium for monthly instalment for six and three months, respectively, this measure is only temporary and unsustainable for the long term. Interestingly, Islamic finance via the profit and loss sharing financing contracts (PLSC) can offer an alternative solution on how businesses and financiers can cooperatively depart from COVID-19 suffering in which businesses act as the share partners as compared to lone-ranger entities, struggling in managing business risk and financing. Against this background, the aim of this note is to contribute to the scant literature on the economic impact of COVID-19 by exploring the role of Islamic finance (via the PLSC) in helping the recovery of COVID-19 economic recession.

It goes without saying that PLSC is the best Islamic contract due to its fairness and justice in wealth creation and income distribution (Siddiqi 1983; Usmani & Zubairi 2002). Besides, the application of interest-based contract (IBC) is against Islamic principles due to the element of usury (*riba*) (Ali 2011; Siddiqi 2004). The prohibition of usury (*riba)* is backed to the Abrahamic religions of Judaism and Christianity (Wilson 1997; Vincent 2014). Even non-religious groups such as the Greek and Roman philosophers, the Code of Hammurabi in 1760 BC, Hindu law (400 BC) and even Plato have condemned *ribawi contracts* (Rehman 2007; Graeber 2014; Taylor & Evans 1987; Anwar 1987). While Islam strictly prohibits *riba*, it encourages Muslim traders to use PLSC. PLSC refers to a mutual contract in which the entrepreneur's physical or mental ability is combined with the financier endowment (fund). By applying PLSC, the financier and the entrepreneur agreed to participate in a specific business in lieu of a share of oncoming profit or loss (if any). The share is determined in a negotiation process before signing the contract. As parties accept to share the outcome of the business which is exposed to many types of risks, they will share in both of the risks and returns of the business (Siddiqi 1983; Chapra 1992; Mirakhor & Zaidi 2007; Farooq 2007; Ajija et al. 2012). Also, it should be noted that PLSC[2], has been a dominant contract for 800 years before middle ages[3] (Lopez 1976; Mirakhor & Zaidi 2007; Rehman 2007; Askari, Iqbal, & Mirakhor 2010). Remarkably, PLSC in the trade in those years are so successful and acknowledged as "the age of the commercial revolution" (Lopez 1976).

Unlike PLSC, IBC behaves differently in distributing the underlying business risks. By applying IBC, the financier requests a pre-determined rate for each unit of his money lending regardless of the actual return produced by the underlying business. It means that the financier shifts the business-related risks to the entrepreneur. As a result, IBC is known as a risk-shifting contract. However, it does not mean the financier is purely free from any risks. It means that unlike PLSC, the financier's return in IBC is free of the underlying investment risks or business risk like the increasing project failures in the tourism and transportation industries due to the partial lockdown of COVID-19 outbreak.

IBC and PLSC are two financial contracts in the global financial market that have their own specific features. While both of them are equal in their functions; channelling money to investment opportunities, they have different effects on risks-adjusted return of the involved participants and macroeconomic variables. While both PLSC and IBC are an applicable contract in the real world, IBC is a dominant contract in the conventional financial system nowadays. Before the appearance of Islam, PLSC was a popular contract in Hejaz (Askari et al. 2014) especially in sharecropping, share-fruiting and other forms of agrarian economy (Dar 1997). Nowadays, PLSC is a regular contract not only in the banking system in Iran, Indonesia, and Pakistan (Sadr & Gholami 2020), but also in different sectors such as the agriculture (Crane & Leatham 1993) or oil industry (Ghandi & Lin 2014). Therefore, various forms of PLSC have been adopted in different economic sectors around the world.

The main feature of an IBC contract is the risk-shifting element from financiers to borrowers. An IBC investor (the agent who applies IBC to invest his money) shifts all underlying project associated risks to the entrepreneur. For instance, in the case of the conventional government bond, the investors hope to get a risk-free rate return while the government bears all the underlying project risks. In other words, the investor's return is free of the business and economic condition risks, regardless of anticipated and unforeseen risk like COVID-19. Consequently, IBC creates a gap between the actual rate of return (i.e. based on business performance) and the investor's return (i.e. based on business net profit with fixed financing cost). Due to the independence of these two returns, IBC generates a dichotomy between the money and real economic sector, conjecturing that the real output from the real economy would not be an important variable for the money supplier. In short, the risk-shifting component is the main culprit that differentiates IBC and PLSC.

Unlike IBC, PLSC is a contract that completely removes the dichotomy between the money market and the real sector. In fact, PLSC is a mutual contract in which all participants work together to make a profit by means of investing their assets including fund, machinery, labour, management's expertise, technology know-how, skills, and so forth.

Contributors can engage in a PLSC either by engaging cash or commodity. In the form of commodity, its market value must be determined (Usmani & Zubairi 2002). As the contract concludes based on mutual consent, the involved participants negotiate on their share (of expected profit) before fulfilling the contract. As they share the profit, which is exposed to business risks, the investor's return is also being influenced by the business risk. Striving out from COVID-19 economic outbreak, PLSC seems to be one of the most suitable financing alternatives as it distributes risks between involved parties based on the earlier negotiation as well as generates a direct link between the money market and the real sector. It is undeniable that PLSC financing exposes the financiers to several challenges such as risky investment, striving in choosing suitable partners, and lack of capital security (Abdul-Rahman & Nor 2017). Nonetheless, empirical evidence have shown that the pass-through mechanism exists between the PLSC financing and *mudharabah*[4] depositors; thus, at least partially offsetting the risky investments from the eye of financial institutions (Abdul-Rahman et al. 2019). In addition, banks that offer huge amount of PLSC financing tend to be more efficient as compared to other banks with the exception of financial crisis period (Othman, Abdul-Majid & Abdul-Rahman 2017).

For the businesses and financiers to move out from the COVID-19 economic crisis, the mind-set of both financiers and entrepreneurs need to be realigned with a common interest. Unlike the typical banking objective, which is to pursue self-interest by maximizing profit, the new financial should be based on social banks, targeting to achieve a common interest of societal and economic sustainability. In doing so, we need to revisit the basic of banking fundamentals. For example, instead of visioning banks as business entities that are driven by self-interest, banks need to redefine its mission as institutions, which are equally inspired by both self-interests and common interests. Moreover, instead of acting as financial intermediaries that lead to bank-borrower relationships, the banks may revise its roles as genuine entrepreneurs, which develop customer-entrepreneur relationships (Abdul-Rahman et al. 2014). Finally, it is also practical that banks adopt the venture capitalist strategies, especially in terms of the customer selection techniques, monitoring, and fund channelling process. Feasibly, the banks may start offering PLSC using its corporate social responsibility funds as an initial exercise towards improving its entrepreneurial capabilities before investing a large amount (Abdul-Rahman, Nor & Salmat 2020) of funds in PLSC financing.

In summary, the editorial note discloses that the Islamic finance via profit and loss sharing financing contract seems to be one of the best approaches towards enriching the resilient financial systems in getting out of COVID-19 economic crisis. A few studies have been highlighted that differentiate the profit-and-loss sharing and the interest-based financing contracts. Paradigm change of mentality of governments, financiers as well as entrepreneurs are required for the financial sustainability.

END NOTES

1. The 22 Pacific island countries and territories of the Pacific Community Are American Samoa, Cook Islands, Fiji, French Polynesia, Guam, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, New Caledonia, Niue, Northern Mariana Islands, Palau, Papua New Guinea, Pitcairn Islands, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu, and Wallis and Futuna.
2. Chapra (1985), Siddiqi (1983 and 2004) and Khan (1995) discuss the nature of contracts in profit-sharing modes of financing.
3. The middle Ages, or medieval time, is generally believed to have started with the fall of the Roman Empire in 476 and to have lasted about 1,000 years until about 1450.
4. *Mudharabah* contact *is a form of Islamic equity-based partnership contract, commonly known as a profit-sharing contract. The capital provider will bear the monetary loss, while the entrepreneur bears the loss in terms of his or her effort. The profit between capital provider and entrepreneur is based on the pre-agreed ratio before the contract is concluded.*

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