RISK SHARING VERSUS RISK TRANSFER IN ISLAMIC FINANCE

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Some recent writings on Islamic finance have resuscitated the old ‘no risk, no gain’ precept from the literature in the wake of current financial crisis. It is argued that the basic reason for the recurrence of such crises is the conventional interest-based financial system that subsists solely on transferring of risks. In contrast, Islam shuns interest and relies on sharing of risks only. The distinction is used to make a case for replacing the conventional system with the Islamic as the way out to a just monetary system free of recurrent financial crises.

This paper does not deal with the linkage between interest, debt, and crises; that linkage is well researched in the mainstream literature. It focuses just on the claim that Islamic finance rests on sharing of risks alone while the conventional exclusively on their transfer. The paper finds the claim ill-informed, and misleading. Islam does encourage profit sharing but the sharing of risk is a consequence of it, not the cause. At the same time, fixed-return financing may not always be devoid of risk. The paper opens with a historical backdrop of conditions in Arabia before Islam to make readers better understand the current cook-up in the area.
Risk sharing versus risk transfer in Islamic finance

The vast devastation the 2007-2008 financial turmoil has inflicted on the global economy has provided the proponents of Islamic finance with a fresh impetus to flog the conventional system and push the divine one, as they understand it, to the fore as a replacement. The development was in some way inevitable for Islam bans both interest and speculation arguably the major culprits in fuelling the current chaos. The ‘no risk, no gain’ dictum and discussion on it were not buried too deep in the literature for its restoration on the pedestal. The revival is led by Prof Abbas Mirakhor. Risk-sharing has been a major theme in his recent lectures and writings on Islamic finance including the books he has co-authored with others. He states his position as follows.

Practitioners grounded in conventional finance, however, were interested in developing ways and means of finance that, while Shari’ah compliant were familiar to and accepted by market players in conventional finance. Scholars emphasized risk-sharing while practitioners focused on traditional methods of conventional finance based on risk transfer and risk shifting. In doing so, instruments of conventional finance were replicated, reverse engineered or retrofitted for Shari’ah compatibility, a somewhat regrettable process. (2014, 107).

The statement may look a bit unclear but taken with statements on the topic in his other writings, it seems to make the basis of his following convictions:

1. That the world financial system is inherently prone to instability and financial crises for the reason that it works through what he calls the transference of risk, not through its sharing.
2. That Islamic financial system which in his view allows nothing but risk sharing could alone pull back the world from the brink of disaster where it now stands.

The propositions, coming from a senior academician and practitioner, carry far reaching policy implications for the future of Islamic finance – its substance and direction. This paper presents a preliminary evaluation of content and tenability of these propositions. To that end, we briefly describe in Section 2 the conditions that obtained in Arabia on the eve of Islam. For, these conditions did play and are playing a role in charting the course that writings on Islamic economics

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1 See for example, Chapra 1986, 166; and 2014, 248) and for more critically examined in recent writings such as Hasan (2005, 11-12) and Syed Ali in Amer Al-Roubaie and ShafiqAlvi (Editors) Islamic Banking and finance, Routledge 2010, Volume III, 2-3).
2 If the participatory financing and the debt-based instruments that dominate Islamic finance are both Shari’ah compliant, the proponents of ‘no risk, no gain’ dictum must discover why the former are not and could not be made popular instead of blaming the system. No industry can go from Kuala Lumpur to Sabah by the fiat of the government, much less to please the scholars, unless conditions conducive to its development are created at Sabah. Not a few writers, including the BNM Governor, have lamented the deficiency off and on (Hasan 2004) but writers reviewing the literature at times leave outside the city wall part of the city already in existence.
3 This paper is based on a presentation of Professor Abbas Mirakhor in a Kuala Lumpur workshop on the subject in 2012 and the publication of a book as a co-author the same year. My reservations on his argument then were presented in an unpolished paper titled Risk-sharing versus risk-transfer in Islamic finance: An evaluation. In his later publications in (2014) he seems diluting his position on the exclusivity of risk sharing for Islamic finance. But that leaves his position all the murkier.
4 This Section is based on Arabia before Islam | A Restatement of the History of Islam.
and finance have taken since their formal introduction in the closing quarter of the preceding century.

Section 3 describes the place of custom in Islam as it follows from the historical background as sketched above. In Section 4 we explain the relationship between risk and return on capital. Section 5 deals with the proposition that Islam allows only sharing of risk as basis of financing. In Section 6 we extend the critical appraisal of the proposition. Finally, Section 7 concludes the argument of the paper with a few observations.

2. HISTORICAL BACKGROUND

Prior to the advent of Islam, there was in Arabia a total absence of political organization in any form. Save in Yemen, the Arabs did not acknowledge any authority other than the chiefs of their tribes. The authority of the tribal chiefs, however, rested, in most cases, on their valor and personality. In character, it was moral rather than political. There was no law in the land except lawlessness. If a crime was committed, the injured party tried to administer punishment to the offender according to its own sense of justice. Between tribes, custom formed a strong basis to dispense justice to avoid wars so frequent in those days.

The more important tribes exercised a certain measure of authority in their respective areas. In Makkah the dominant tribe was the Quraysh; they had settled there and considered themselves superior to the nomadic Bedouins while the latter had only contempt for the town-dwellers who they considered only a shopkeepers’ clan. The Arab and Jewish tribes dominated Yathrib (present Medina).

The Arabs were following a variety of religions. Broadly, there were Idol-worshippers or polytheists. They worshipped numerous idols and each tribe had its own idol or idols. Prophet Ibrahim and his son, Ismael (peace is upon them) had built the Kaba for service of One God but the idolaters had converted it into a house having 360 idols of stone and wood.

Then there were the atheists who thought that the world just exists; it had no creator. They were materialist to the core. Then there were Zidiqs who believed in two gods – one for good, the other for evil. Some worshiped stars.

The Jews were refugees whom Romans drove out of Palestine and Syria; they found new home in the Hejaz, a part of Arabia. Some clans that Romans converted to Christianity had also settled there while others lived in Yemen.

Finally, there was a small group of monotheists present in Arabia before the dawn of Islam. Most of the Banu Hashim clan including the families of Muhammad, the future prophet, and of Ali ibn Abi Talib, a future caliph, belonged to this group. Its members were the followers of Prophet Ibrahim – peace are upon him; they did not worship idols.

The Jews were the economic leaders of Arabia. They owned the best of the cultivable lands in Hejaz, and were the leading farmers there. They were also the craftsmen and had monopoly in making the armaments of the time.

The most powerful social class - irrespective of the clan - included traders and moneylenders. Profits taken were high and the rates of interest on loans exorbitant, making them increasingly rich and the masses poor. These traders and moneylenders were concentrated in the urban centers,
especially Makka. The arrival and departures of caravans were the most important events for those living in Makka. Almost everyone in the town had some kind of investment in the wealth brought in by thousands of camels, the hundreds of men, horses and donkeys that travelled out with hides, raisins and silver bars and returned with silk, oils, perfumes and manufactured goods from Syria, Egypt and Persia and with spices and gold from the south.

In Yathrib, the Arabs made their living by farming, and the Jews made theirs’ as businessmen and artisan evel as among them were farmers as well; they had brought much waste land under cultivation.

Trade promised more and quick wealth but was hazardous too involving long distance travels with scant security on the way. Many people having money and longing to invest for wealth were averse to undertake travel because of age, health, or dislike; women having little chance. Such people gave their money, materials or goods to other traders or empty-handed persons(mudarib) to indulge in trading on their behalf for a share in profit, loss if any being theirs. This mode of trading known as mudharabah was thus pre-Islamic and compulsive in nature...

Slavery was an economic institution not only in Arabia but across the world. Male and female slaves were sold and bought like animals, and they formed the most depressed class of the society every where.

3. CUSTOM AND ISLAM

This brief sketch of pre-Islamic socio-economic scenario in Arabia helps identify a few things of substance and significance for a clearer understanding of the reforms Islam introduced after its advent. The reader may have noted that custom was the only law to regulate behavior and settle disputes, largely on the basis of equivalence – an eye for an eye, a tooth for a tooth. Islam maintained this norm but pleaded that forgiveness and compassion carry a much higher reward with Allah only if people understood.

Trade was the important source of becoming rich followed by money lending, though manufacturing and agriculture too existed. Loans were largely for consumption purposes, rates of interest were exorbitant. At the same time, the return of debt plus interest carried sanctity – the methods allowed for recovery were thus cruel.

Islam, being a way of living, maintained, rather enhanced the customary respect for trade and the traders. Travelers had to be helped and taken care of. Presumably, the historical sway of trade still dominates the Muslim world. Muslim countries taken together have more than 60% of the basic global resources – actual plus potential – but produce no more than 8% of the world GDP. The trade their resources for importing consumable wealth but little to erect production capacities even as it is known that the power to create wealth is more important than the wealth itself. Note that a liter of Coca Cola brings in more money than a liter of crude.

Islam abolished interest, promoted creating ease for loan repayment including extension of time without extra charge. However, the return of the principal stayed holding customary sanctity – the

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5 This was why Islam held trade and the traders in high esteem. A prophetic tradition says that 90% of the wealth that all occupations create comes from trade. Another has the tiding that traders will be raised with the prophets and the martyrs on the Day of Judgment.
Prophet (pbuh) refused to lead the burial prayer of a dead until someone of those present cleared his debt obligation.

*Mudharabah* emerged as an institution for trading as circumstantial compulsion, not as an inviolable principle. The position of the financier vis-à-vis the worker (entrepreneur) was weak depending on the trust in the integrity of the latter. That equation has long reversed.

Interestingly, the principle of limited liability the crux of modern financing arrangements was all along implied in *mudharabah* contracts. It was circumstantial that the primary sources of Islamic jurisprudence did not make it explicit. Let it be noted that the liability of the financier in the case of loss was never to exceed the money he gave to the worker to trade on his behalf. This implicit rule operates even today in Islamic financial contracts. It is patently incorrect to claim, as some writers do, that the emergence of limited liability was a post-industrial Western innovation. It is all the more naïve to regard a non-existent parameter as the main cause of arresting development in the post-colonial Muslim world.6

Before Islam, slavery too was customarsince times immemorial for a variety of reasons including the means for ensured supply of labour to run economic activity.7 The institution was so entrenched that even Islam that abolished such deep rooted practices as interest, gambling and intoxication without waiting did not consider it expedient to shun slavery the same way. Instead, it encouraged the freeing of slaves, equality with the masters in matters of feeding and clothing them as well as treating them with kindness. One of the *zakah* expenditure heads was allocated to buy the freedom for slaves. The result was that slavery in general ended in the Muslim lands faster than elsewhere. And during the interval slaves rose in social ranks to become knights and viziers, even rulers! Islam abhorred apartheid irrespective of shape or form.

The eventual extinction of slavery provides an important lesson: However important and well-rooted may the customs be they are not eternal beyond social expedience. They must go if they no longer have need and merit. Islamic history is replete with testimony to this guiding principle. Forms and modes for business activity are no exception. Orthodoxy is giving way to modernity, more so in financing.

**4. RISK AND RETURN ON CAPITAL**

Initially, the association of risk with return on capital emerged to justify the charging of interest on loans largely taken to meet basic survival needs or perform social rituals (Rubin 2011, 1313). The

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6We do not want to make digression from the main theme of this paper to discuss the issue of retarded economic development in the Muslim world. Suffice to say that the plunder of the colonies by the Western masters and its unabated continuation in various ways even after their independence has been one of the major causes of their current plight.

7Millenniums before Islam, when the Great Pyramid in Egypt was under construction, Pharaoh’s soldiers had enslaved thousands of men from far and near to work on the construction. They got a loaf of bread and an onion twice a day to live on. At night their legs were chained together lest they might escape under the cover of darkness. At some point in time for unknown reasons onion was withdrawn from their daily ration. They declared strike unless their onion was restored. The Pharaoh got so furious that he ordered the killing of all slaves for the disobedience. But a minister saved the day for them. He argued as to how the pyramid would be completed if the order was carried out; such a large labour force was not possible to reassemble so readily. The king withdrew the order and the onion was restored. The All India Radio once narrated the story under the title: The first successful labour strike of the world and that too for an onion.
flow of money was from the rich to the poor in society. The rates of interest were exploitative as most borrowings did not create the means for their own repayment. In default, the transfer of productive assets from the poor to the rich was the common scenario. Emergence of grinding poverty and abhorrent distributional inequalities of wealth and prosperity was the consequence.  

There was some lending for productive activities also but during the early era of industrial expansion (1775-1825) men normally used their own capital in dominant industries, hiring labor and renting land from others. The managerial function centered in the capitalist Competition was moderate. Thus, Marshall in his Principles (1898) could talk of tiny owner-operated firms dotting an industry as trees in a forest; the trees growing and falling on their own strength while the industry continued on its forward march.

In this early era of industry, the income of the business-manager naturally got linked with the ownership of capital. In all the classical writings we find the word "profit" used in this sense. But this association gave rise to much confusion in economic theory as interest also went to the owners of capital. Also, under competitive conditions, profit in the long-run could not but be "normal" which could hardly be much different from interest. Early classical writers could not provide a basis to separate the two or justify their accrual to the same functionary – the capitalist. (Knight 1921, 23)

Later day economists, found the distinction between interest and profit by linking profit to risk albeit they saw a profit element in interest associated with risk. We shall comment on this distinction later, but Knight (1921) threw all risk theories of profit out of the window with a simple argument. Put briefly, it runs as follows. Perfect competition where participants in production have by assumption complete information of the market and enjoy perfect mobility, economic profit must be zero. The return to capital must be identical with riskless market rate of interest. Dynamic change that cannot be foreseen makes competition imperfect and business ventures become risky. Risk divides society into two sorts of people. Most people prefer to have sure incomes, not variable. For such guarantee they are willing to work for others. This is possible for there are some others in a society who are willing to do so in the hope that what remains after making such payments from earnings of business will be theirs. Thus risk divides society into the hired and un-hired factors of production; the latter being the risk-takers – the entrepreneurs. Thus, came into vogue the residual claimant theory of profit for rewarding the entrepreneurs for their work.

Knight regards the possession of capital a necessary condition for entrepreneurship as in his view an empty handed person cannot guarantee contractual payments to the hired factors of production – land and labor. Interestingly, he does not see any connection between profit and capital;

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8 Thus, Christianity and later Islam on its advent both put restrictions on interest. But with the rise in commerce Christianity went on relaxing the restrictions ending them completely by the year 1836. In contrast, restrictions became tighter in Islam leading to its total abolition. (Rubin 2011, 1313, 1315).

9I have elsewhere suggested the case of two men ("workers") proposing to carry out a project together, with no other factors involved. They would have a choice: either to negotiate agreement in advance on all details of what is to be done by each and the sharing of the result; or, a much simpler arrangement would be for one of them to take charge and assure to the other a more or less definite return, his own "share" (positive or negative) to depend on the outcome. In a social ethos of free contract, the latter seems to be the more natural recourse, unless there is a "familial" relation between the parties. This hypothetical case exemplifies all the theoretic essentials of entrepreneurship and profit. (Knight: Preface to the 1957 Edition, Ixia).
it is a reward for entrepreneurial services\textsuperscript{10}. The proposition must create problem for the proponents of the ‘no risk, no gain’ proponents in Islamic finance. For, they do not regard the possession of capital as a pre-requisite for entrepreneurship, nor do they deprive the capital owner of a share in profit. But let that not detain us here. More damaging is Knight’s treatment of risk in his work.

Knight divides risk in two parts – measureable risks and un-measureable risks which he labels as risk proper or uncertainty. Measurable risks can be insured at a cost; thus they pose no threat to business and cannot be associated with profit. The premium paid to the insurer is a cost element like wages or rent the businesses pay. It is uncertainty the un-measurable risk that forces us to peep into the future but the result would depend on luck or chance. The bifurcation is of far reaching consequence for finance, especially Islamic where gharar or uncertainty has to be avoided.

Indeed, unless one is able to refute the logic of the bifurcation, most risk-management flights in modern finance – Islamic or conventional – must be grounded. For, measurable risk must be insured; the un-measurable one or uncertainty we have no means to guard against. Beyond what can be insured, twakal alone is the best risk management in Islam. Indeed, the present day risk management does not as it cannot measure total risk due to an un-miserable mix. Risk managers measure probable (insurable) loss and to avoid it incur a cost possibly higher than the insurance premium\textsuperscript{11}.

Also, the risk-profit linkage we referred to above cannot be shown as equitable. No one-on-one correspondence can be established between risk and profit, uncertainty being a part of the former. In addition, even if granted, risk-profit linkage is but ex ante whereas the negotiated sharing of profit is for ex post division when no risk exists. Islam allows sharing of profit of which risk sharing is a result not the cause.

Finally, Islamic financial institutions are all using the conventional interest rate as the benchmark to fix mark-ups in their sale contracts. If a sharing of risk with interest banned; as the proponents want, replaces the present conventional arrangement, what shall we use as a reference point to gauge the fairness of profit rate in the economy? One is not clear. There has to be a base as the sea level in geography for measuring heights for contributing to the stability of the system. Debt-based Shari’ah compliant contracts presumably perform that function in Islamic finance?

5. THE ‘NO RISK NO GAIN’ ADAGE

The present resurgence of risk-sharing is the echo of the ‘no-risk-no-gain’ adage paraded long in the literature as the sole principle for organizing Islamic finance during the latter half of the preceding century\textsuperscript{12}. The present author had a detailed discussion on the precept in an earlier article (Hasan, 2004, 16-18). The reiteration of the precept under review tends to rely essentially on evidence

\textsuperscript{10}Knight continues: In exposition I should now strive for a somewhat sharper analysis, stressing especially that there is no connection between profit and the use of property.

\textsuperscript{11}There is a fundamental difference between the reward for taking a known risk and that for assuming a risk whose value itself is not known. Risk managers can measure only the mathematical probability of loss – the known risk but a known risk will not lead to any reward or special payment at all (Knight 1.11.38).

\textsuperscript{12}Chapra (1986) epitomized the mention in the prevailing literature in the adage; See especially PP 64, 166.
extracted from the mainstream sources rather than from earlier reasoning and analysis in Islamic finance. The mainstream literature in economics is growing fast and is so vast that evidence can often be marshaled on either side in a debate including risk-sharing with impressive documentation.\textsuperscript{13} Important, however, is to examine the logic behind a theoretical proposition.

The risk-sharing precept got currency in Islamic finance literature with the passage of time until it was challenged in the mid-1980s first by some professional bankers in Malaysia and later in academic writings. There was a pause for a while but it could not continue for long. The 2007-2008 financial turmoil gave a fresh stimulus to advocacy for the precept.

The argument for the ‘no risk no gain’ proposition rests on a rather oblique interpretation of the Qur’anic verse 2:275 which in the relevant part declares:

\textit{Allah hath permitted trade and forbidden usury.} (Yusof Ali Abdullah)

The verse ordains that all economic and financial transactions are to be conducted through contracts of exchange (\textit{al-bai’}) and not through interest-based debt contracts. This much no one can dispute. However, the proponents further insist that requiring contracts to be based on exchange inter alia implies that Islam considers contracts based on interest unfair and inequitable \textit{because interest shifts the risks of financial transactions to the borrower}. It is argued that exchange being the characteristic of sale \textit{allows} the risk of transactions to be shared (Osman & Mirakhor 2014, P.65 emphasis added).

Now, \textit{riba} is banned not because it transfers risk to the borrower but because the lender offers no compensatory value for it in real terms; more on this later. Exchange \textit{allows} e.i. does not insist on risk-sharing being a necessary condition for a valid contract. \textit{Al bai} in its generic sense encompasses all contracts whereby a given quantity of one commodity or service is exchanged for a given quantity of another commodity - including money – or service unless forbidden by the \textit{Shari’ah}. The transaction may be completed on the spot; both parties gain without facing any risk. Also, the obligation of one of the parties may be deferred for completion to a future date by mutual agreement – salam sale, sale on order (\textit{istikna}) or leasing (\textit{ijara}) are the leading examples. Such transactions do involve risk but the essence of the contract, we shall see, is not risk sharing.

Again, the implication of the precept that capital alone is the factor exposed to risk in production is not correct: This essentially is a matter of definition; risk and reward are both pinned to capital investment in the free markets doctrine\textsuperscript{11}. The risk that human beings face while working in various sorts of production lines are ignored even as such risks could be more persistent and damaging to limbs and life compared to loss of money. Men, women and children working in coal mines, glass blowing, cement factories, cotton ginning, on oil-platforms in open seas, on nuclear reactors or even controlling traffic at the crowded road crossings face hazards no amount of money can compensate. During cyclical ups and downs who suffer more – capital or workers -depends on the terms of contracts that govern their employment. If there is a case for risk (and profit) sharing among the

\textsuperscript{12}The classification of the notes and references in one such study of repute confirms the generous borrowings from the mainstream sources; some even from the heterodox literature. The bibliography contains 325 entries. Only 75 of these are from Islamic writers. Of the 75 no less than 40 belong to the writers of the book itself. Thus, for the criticism of the mainstream positions too our scholarship essentially draws on the mainstream!
providers of capital, there is one even stronger for sharing between labour and capital, especially from Islamic viewpoint (Hasan, 1975).

A further assertion of the ‘no risk, no gain’ proponents that interest-based finance is entirely risk-free; the risk is transferred to others. It is again untenable. Conventional lenders do face risks of default regarding the principal and/or interest. Interest rate faces fluctuations via the bond market. If interest-based finance were entirely devoid of risk, could mighty financial institutions have collapsed as they did in the current turmoil? Again, is there any worthwhile estimate as to how much risk conventional institutions transfer to others? What capital faces in deferred payment Islamic contracts is not much different from conventional risks even as mortgage provides cover in both cases. If there is difference between equity and debt with reference to risk, it is of degree, not of kind. Sharing of risk may involve its transfer. There could be cases as sleeping mudarabah where one can legitimately see risk-transfer in risk-sharing.

Finally, another distinction the proponents make relates to the fixity versus variation of payments – interest and profit. It is argued that fixed return to capital is not allowed in Islam, not even its use as a benchmark is permitted. This is only partially true. Islam does allow a time value to money as part of price in deferred payment contracts based on murabahah, the cost plus an agreed fixed margin financing mode. Deferred payments sales involving mark-ups are debt based transactions. We are not aware of any juridical preference between contracts involving profit sharing on the one hand and those stipulating pre-determined returns on the other if both meet the stipulated Shari’ah requirements.

6. BASIC CRITICISM

Frank H. Knight was categorical that profit was not a return to capital; it was a reward for entrepreneurial services of direction and coordination. But by the time he was writing the preface to the fourth edition of his *Risk, profit and uncertainty* in 1957, the corporate form of business organization has risen to dominance, the personality of the classical entrepreneur had disintegrated decision making became scattered throughout the managerial hierarchy and competition had become intense; the big fish eating the smaller one in the pool. What remained intact of his work was the distinction between risk and uncertainty and its implications for economic theory and practice.

The distinction shows that risk taking cannot be planned to produce desired results. It could be a personality trait but cannot be measured and no economic value can be put on it. Thus, risk is a specific mental state that instills in a person the fear of adverse consequences of an action, for example the fear of losing his capital as an investor. Two options are open to the capital owner:

(i) He is free to desist from the action if he cannot overcome the fear of adversity – losing money; no one would penalize him if he does, or

(ii) He must conquer his fear and act and take whatever be the consequence.

14 If there was little agreement on the identification of the entrepreneur in a modern corporation there was even less on the functions he performed. The concept has melted down into a heuristic analytical tool with little real content. His uncertainty theory reduced to a windfall profit case of little significance.
Risk-taking is purely discretionary for humans. For that reason Islam neither promises a reward to a risk-taker nor it refuses a reward unless risk is taken. Consider the following examples as evidence.

1. One can earn a profit in spot transactions without facing any risk. The post price risk one takes out of his sweet will; it does not arise in the course of spot sale and purchase. Pecuniary gains arise in the form of wages or rent for contributing to the permitted productive effort.

2. **Abolition of interest**: One justification capitalism advances for charging interest is the element of risk involved in lending. Thus, the lender has a right to compensation in the form of interest. No Islamic economist can deny that loans carry risk; why then Islam bans interest? Simply because interest is not the result of any productive exertion undertaken by the lender.

3. **Ban on gambling**: Like interest, Islam prohibits gambling and earnings based on it albeit gamblers take great risks, are even ruined. The reason again is that labour in gambling is unproductive in the Islamic sense.

   The ban on gambling extends to the sharing of individual earnings pool also. To illustrate, *Shari‘ah* would not allow two doctors entering into partnership to take patients separately but pool their earnings to be shared in a pre-agreed ratio. Why, to avoid risk of anyone of the two not getting the just reward for his work due to the possibility of a plus or minus element brought in by the sharing of risk.

4. **Tools of production**: The tools of production are not allowed to have a share in the profits of a venture even though they too are exposed to risk in the process. But tool owners are not denied a return; they gain in the form of fixed returns (Rentals).

5. Some other earnings involving risk disallowed: Certain sources of income (gain) like magic, witchcraft, fortune-telling or jugglery are not allowed in Islam even if risk is involved because they do not contribute to socially useful production.

These all and the like are the ways of eating each other’s wealth in vanity as no *trade* with mutual consent is involved (Qur’an 2:188; 4:129). Even as risk may be involved, gain/profit may not be legal. The permissible way of generating profit and its sharing are allowed in all cases where participants can be shown as contributing to socially useful production. Baqir-as-Sadr (1984, 76) laments as follows:

“Many have fallen into error influenced by capitalist thought which has a tendency to explain the point and its defense on the basis of risk. They say or have said that the profit allowed to the owner of the stock-in-trade (cash capital or commodity) in the mudarabah contract is theoretically based on risk because even though the owner of the stock-in-trade does not do any work yet he bears the burden of the risk and exposes himself to loss over his cash or commodity to the agent trafficking with it; so it is the duty of the agent to make proportionate percentage of compensation against the ventured risk out of the profit agreed upon in the mudarabah contract between them.

But the fact has been made fully clear in the previous discussion that the profit which the owner of the cash or commodity obtains as a result of the agent’s trafficking of it is not based on the risk but receives its justification on the basis of proprietorship of the owner of the cash or commodity with which the agent traffics”.
If one wants to make risk-sharing the unshared fulcrum of Islamic finance, one must better take an extended view of risk and show its applicability in various socio-economic conditions as harmonizing with Islamic norms of justice. An attempt to do so has to be comprehensive and complete. Any such attempt would raise insoluble problems.

Presumably, the risk-reward equation is being grossly overdone; the profit which the owner of a commodity obtains through its sale is based not on the risk he takes but on the basis of the commodity proprietorship, even if the price increases due to his transferring the commodity to the market for ready availability to the consumers, for he continues to remain its owner (Baqir-as-Sadr 1984, 75-76).

At times the proponents of risk-sharing switch over from mundane to the cosmic world in their expositions without notice or forging a link between the two sets of argumentation. To us, the possible link seems to be in interpreting cosmic as application of the Divine intent to the totality of social existence. If this view is acceptable, risk-sharing must be applied in all walks of life not to between business capital providers alone.

Take just one illustration at the micro level: the labour-capital relations in production. Both factors are exposed to risk of different sorts though. Market capitalism is worried about the risk of losing money and material but wary of the risks to which limb and life of the workers are exposed. Palpably, both labour and capital join hands in producing the resultant output; it is the outcome of their combinational productivity. Its current division between profit and wages is arbitrary unless labour gets a share in profit subject to a minimum wage constraint (Hasan 1975 and 1983). The proponents of risk-sharing in Islamic finance invariably remain silent on such issues in their cosmic discussions on Islamic injunctions.

No less dubious is the exclusionist approach of the risk-sharing advocates. Consequently, some crucial questions remain unanswered: Would mainstream finance that rest essentially on the institution of interest and is blamed for risk-shifting welcome the proposed replacement, given its global dominance? More than that, can Islamic finance survive purely on risk-taking? Arguably, it is not the case of risk-sharing or risk-transfer; it is a case of building appropriate trade-off between the two, irrespective of the system – conventional or Islamic. If conventional banks could indeed shift all their risk to clients in the current crisis, the clients alone would have suffered. That mighty banks crumbled like sand walls was only proof that they had taken excessive risks i.e. beyond their capacity. In the same way, the participatory finance in Islam entails the shifting of risk partially to the depositors. Calling it risk sharing or shifting is a matter of taste, not of principle.

7. CONCLUDING REMARKS

This paper aimed at examining the logic and feasibility of an old precept recently sought to be revived in Islamic economics. The precept says that Shari‘ah permits no gain unless risk is involved

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15 Many classical jurists had indeed classified mudaraba as ijara bi-l-gharar; hire with (forbidden if excessive) uncertain wage. The contract may even include an element of riba, if the profit share is not commensurate with the work done, fairness being determined by the market wage. (El-Gamal 2014)
in its earning. It is argued that risk-sharing alone is commensurate with Islamic norms of financing. They blame increasing recurrence of financial crises on the interest-based finance because it promotes transfer of risks not their sharing. Islam bans interest and allows only sharing of risks in financing – not their transfer. This critique has highlighted unacceptability of the above argument on both the juridical and feasibility fronts.

Interest based financing is not altogether devoid of risk taking; nor all transactions in Islamic finance are based on risk-sharing in the same way as equity. It is interesting that the Kuala Lumpur declaration of October 1, 2012 on Risk-Sharing as an alternative to interest based finance skirted around the proposal only to say this much:

“Governments should endeavour to move away from interest-based systems towards enhancing risk-sharing systems by leveling the playing field between equity and debt”. 16

The paper concludes that ‘no risk, no gain cannot be defended as an exclusive principle of Islamic finance. Risk is not a tradable commodity or an act in itself contributing to the value of output. Many transactions involving risk are not allowed while many transactions not involving any risk are. Sharing of profit and loss is valid but its basis is not the existence or absence of risk.

Finally, in evaluating a situation and its causes the moral and ethical dimension invariably escapes our attention. Principles of economics are essentially principles of economic policy and no policy is worth more than what it is in implementation. An IDB publication aptly says:

“At its heart, Islamic finance is a moral system of finance. It emphasizes the balance between for-profit activities, or the market, and not-for-profit activities, including social and philanthropic activities. No economy can enjoy sustainable prosperity without the two domains in healthy equilibrium. Just as a bird cannot fly smoothly without the two wings properly functioning in tandem, an economy cannot “fly” without the two domains properly operating and serving the common good of the society.”

Most of the writings in the area of Islamic economics and finance are oblivious to the fact that the moral wing of the bird today is utterly non-functional, if not broken. They present their postulates on the tacit assumption that people are reasonably committed to moral and ethical norms which unfortunately is not the case. When confronted with the choice of reaping economic benefits or obeying religious imperatives worldly concerns tend to overweigh the hereafter consideration seven among the pious.18

The proponents of making risk-sharing the sole basis of Islamic finance should re-evaluate Shari’ah base of their argument. In any case, risk-taking is not the same thing as risk-sharing. They should also evaluate the feasibility of such suggestions as erecting a new stock exchange that they think would enable equity-based financing replace debt-based instruments like sukuk

16 It is notable that in their moiré recent writings the proponents have given up their exclusivist approach to the financing instruments and with that itself liquidates their earlier approach to the issue.
17 Presumably, the exclusivity has no historical evidence as well even as Murat Cizaka, a historian of Islamic finance, writes: "Thus, it follows that Islam prefers risk sharing to risk shifting (2014, 1).
18 Malik et al (2011, 45) make an interesting point on risk-sharing referring to sukuk. They say “Islamic investors are supposed to be justified by risk-sharing, the notion of taking on each other’s burden. With sukuk, however, the main risk for the investors is of default, and in such circumstances the investors can be expected to instigate legal proceedings against the issuer to try to reclaim as much of their investment as possible.” Withers the sharing spirit!
that have become well-entrenched in the system and dominate it. (Rudnyckyj, 2014, 123). Their indiscreet acceptance may lead to non-delivery, possibly to disastrous result.

No finality is claimed for the observations made or conclusions drawn herein. A major objective of this paper was to initiate debate and discussion on an important subject in the area of Islamic finance. Comments and criticism if any are welcome for revision.

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