Risk-sharing versus risk-transfer in finance: A critique

Zubair Hasan

Global University of Islamic Finance (INCEIF) Kuala Lumpur

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Abstract
Some recent writings on Islamic finance have resuscitated the old ‘no risk, no gain’ precept from
the earlier literature in the wake of current financial crisis. They argue that the basic reason for
the recurrence of such crises is the conventional interest-based financial system that rests purely
on transfer of risks. In contrast, Islam shuns interest and promotes sharing of risks, not their
transfer. The distinction is used to make a case for replacing the conventional system with the
Islamic; for that alone is the way to ensuring the establishment of a just and stable crisis free
economic system. Islamic banks have faced the current crisis better than the conventional is
cited as evidence.

This paper is a critique of this line of argument and concludes that the case is for reform not
for replacement of the current system marked with increasing duality.

Key words: Financial crisis; Risk-Sharing; Risk-Transfer; Islamic system; KL Declaration

1. INTRODUCTION

Firms need finance to establish and expand their business. These needs can be met by issuing
equity shares or by borrowing money from financiers if the firm owners are not having or willing
to commit additional funds to business. There is no dearth of discussions in the literature on the
circumstances appropriate for using either of the two sources or their proper mix in modern
corporate businesses. In broad terms, reliance on equity is advised for imparting
stability to
business over the long-run while debt financing is considered suitable to cover temporary, rather
smaller, liquidity requirements.

However, in recent years, the ease of combining the long-run advantages of equity finance
with short-run debt leveraging gains via maturity transformation2 has led to an increasing
reliance on debt financing (Hasan 2014, 192). Leveraging enhances returns on investment for
both the seekers and the suppliers of funds albeit in different ways. In general, the lure has led to
a reckless use of maturity transformation and the resulting gains have become one major
causative factor in recurrent financial crises worldwide.

The 2007 crisis originating in the US is the latest example of such lure-led turmoil. Many
financial institutions, mostly banks, soon discovered to their dismay that they were awfully short
of liquid assets to meet deposit withdrawals because of the mounting debt defaults. Bankruptcy

* Zubair Hasan is professor of Islamic economics and finance at the Global University of Islamic Finance (INCEIF),
Kuala Lumpur, Malaysia. The views expressed herein are of the author and need not be attributed in any way to the
institution where he works
2 Maturity transformation refers to the use of rolling-over of short-term loan several times to finance long-term
needs.
stared them in the face. The gravity of such eventuality necessitated massive bailouts from public funds as large sized financial institutions were considered as being ‘too big to fail’. The volume of resources these institutions held and the employment they provided made keeping them afloat a compelling social need. Cost estimates widely differ but big sums are indicated. By the year 2009 bailout cost touched, according to one report, $4 trillion in the US alone; almost 10% of the national GDP.\(^2\) The turmoil has humbled the Schumpeterian pride of hailing capitalism for destroying the old structures only to innovate the better ones on its forward march to progress and prosperity.

At a time when the world is still groping to find a way out of the dark tunnel the equity-debt debate has once more assumed importance in the literature and with an additional dimension. Public waywardness is no less on the target than private lure. Due to a public-private mix in fomenting the trouble, the search for solution to guard the future no longer remains restricted to monetary policy or national boundaries. It has spilled over to governmental machinations and transcended political jurisdictions in a big way as flows of men money and materials across border have grown in importance. There is talk of a paradigm shift in financial economics\(^5\).

The shift 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. Contextual to the equity-debt debate, the ‘no risk, no gain’ dictum and discussion on it were not buried too deep in the literature.\(^4\) Its present restoration on the pedestal 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. The turmoil gave him the opportunity to postulate:

1. That the world financial system is inherently prone to instability and financial crises because 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 the content and tenability of the propositions. It argues that the stated cause of turmoil has some important missing and the solution offered rests on inexplicable presentation of Islamic positions.

In the following Section 2 the paper takes a hurried look at the causes of the current turmoil to see what it indeed was that has to be blamed for the collapse of the system. In Section 3 we

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\(^4\)See for example, Chapra 1986) and for more critically examined in recent writings such as Hasan (2005, 11-12) and Syed Ali in Amer Al- Roubaie and Shafiq Alvi(Ed.) Islamic Banking and finance, Routledge 2010, Volume III,2-3).
shall examine the genesis and place of the ‘no risk, no gain’ dictum in Islamic finance. Section 4 discusses the argument supporting Islamic system as a replacement for the conventional. It also evaluates if risk-sharing could be the exclusive base for organizing Islamic finance. Finally, Section 5 presents the findings of the paper and contains a few concluding observations.

2. THE DEVASTATION AND ITS CAUSES

We have referred to above to an increasing inter-action between financial sector and public policy in modern economies. The continual erosion of the central banks’ freedom in regulatory matters allowed commercial banks to manipulate rules to become extra venturesome for self-enrichment only to land in trouble. As public policies were part of the trouble gourmets had to rescue them instead of the hapless depositors.

The frequency, depth, and the duration of financial crises have increased especially after the collapse of gold standard in 1971. Economic history of the two decades ending with the turn of the century bears ample testimony to the fact. The following Figure 1 sketches the experience of 10 developed countries showing the bank-bailout cost and its percentage to the GDP of each. Notice that all percentages, except for Sweden, have been more than 10%, the current rate for the USA being currently equal to 100%.

Even the much maligned sub-prime debacle as initiator of the current crisis was not entirely the result of the bankers’ oblique risk-transfer behaviour. The fed followed a cheap money policy even to the extent of making real interest rates negative. Figure 2 is indeed revealing. Here the 12-month change in the consumer price index is subtracted from the month-end 10-year Treasury Note yield However, at the same time, a home expansion public policy announcement continued pushing up property prices unabated. Figure 3 puts the two parts of the story together. A comparison of its X, Y and Z sections unmistakably brings out a negative relationship between interest and property price changes. We are not building a defence against systemic failures.
The leverage lure we alluded to earlier lead to massive failures of banks and other financial institutions in the wake of the 2007 subprime US debacle and catapulted the equity-debt issue.

Islamic critics have highlighted. Our point is that one cannot be oblivion to the contribution of human mischief contributing to the crisis in no less a measure if not more.

The leverage lure we alluded to earlier lead to massive failures of banks and other financial institutions in the wake of the 2007 subprime US debacle and catapulted the equity-debt issue.
out of the business finance box on to the vast arena of public policy. The change has imparted to the debate macro-dimensions of magnitude and significance. The enormity of the issue has defied all conceivable limits. Attention has shifted fast to a search for appropriate action to overcome the economic fiascos that threatens to engulf the globe so often. Paramount has become the question: what could be done to obliterate the devastating debt menace to make finance harmonize with the broader economic objectives of growth, stability, full employment, amelioration of poverty and improve justice in wealth distribution? These objectives commensurate well with the Islamic maqasid

The search for a remedial action has resurrected the equity-debt debate in the literature. But this time it has assumed one more dimension; public folly is no less on target than private exuberance. Due to a private-public mix in fomenting the turmoil, the search for solutions to guard the future no longer remains restricted to monetary policy or national boundaries. It has spilled over to governmental machinations and transcended political jurisdictions in a big way as cross border flows of men money and materials have fast grown in importance. There is talk of a paradigm shift in financial economics. The shift has provided the proponents of Islamic finance with a fresh impetus to flog the conventional system and push forth the divine one, as they understand it, to the fore as a replacement.

3. FINANCIAL CRISIS AND ISLAMIC BANKS

One demonstration supportive of the replacement proposal is that Islamic banks have shown greater resilience during the recent financial turmoil compared to their conventional counterparts for the facts that they have had comfortable liquidity buffers, low leverage ratios, better managerial skills, and more customized sort of products. The demonstration doubtless has much merit but not all for the stated reasons. A counter argument seems no less weighty. It is said that Islamic finance is yet too small in terms of market share; it has not yet developed sufficient connectivity with the global system to catch the cold. Overall, Islamic banks do have better liquidity cushion but more as a problem than merit – many are not able to use effectively the investible surplus they are able to generate in terms of deposits. The evidence cited is as follows.

Trade is the transmission channel for the spread of a contagion across countries; its volume measures the strength of their mutual connectivity. The economies of 57 OIC countries are a highly heterogeneous group; 22 of them are among the least developed nations of the world; 19 are the fuel exporting rich. The share of OIC countries in the global trade was just 10% in 2010. Furthermore, this share is very unevenly distributed; the major portion going to the fuel-rich exporters. And, it was the magnitude of these countries trade that some gulf banks did come to grief during the turmoil (Hasan 2010, 50-51). As the OIC countries develop over time, the increase in their global trade channels can be controlled only through increasing the intra-OIC trade to contain possible infection. Efforts in that direction are being made. There is a plan in

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5Islamic Banking and Finance Institutions (IBFIs) with their current structure have not been able to affect nor have they aimed at affecting the development of the societies in which they operate though this does not mean that IBFIs do not have an impact on economic growth (Mehmet Asutay 2012 P.110).
place to attain a 20% share of total OIC trade within the group. However, the pace of diversion is quite slow due to the very diverse nature of exports and imports of the member countries as Figure 4 pertaining to their trade reveals.

Anyway, the validity of the reasons given for Islamic banks facing the crisis better is not the issue in dispute. In dispute here is the claim that interest promotes the transfer of risk the abolition of which in the Islamic system that allows only risk-sharing would cure the malady. In other words, sharing of the risks sans transfer is an imperative for escaping the recurrent financial crises and which is what could alone ensure stable economic growth. It is on this premise that Abbas and others present Islamic finance as an alternative to the current interest-based system. The following section attempts to measure the strength of this line of argumentation.

4. RISK SHARING: THE SOLE BASIS OF FINANCING?

We raise three issues to scan the replacement advocacy

i. How we define risk and fix its ambit?
ii. Is the implication underlying the claim that Islam does not allow using financial instruments other than those based on risk-sharing tenable?
iii. Finally, can a risk-sharing financial system be shown as logical just and operable?

We look at the issues these questions raise in the in the following discussion in that order.
Risk: concept and applicability

Risk refers to the possible shrinkage in the value of something due to uncertainties of the future course of events; the shrinkage could be partial or total. Income, assets, employment, health, goodwill, self-esteem, prestige, environs and so on are all exposed to risk in the stated sense. Apparently, one risk might look independent of (some) others but in the individual and social dynamics they mesh together as do colours in a painting for creating an overall intuitive effect.

A cardinal measure of risk based on probability theory is dubious and cannot be relied upon for ensuring justice in sharing. In any case, it can be insured against at a cost. Un-measurable uncertainty poses true risk. That distinction apart, we cannot show a one on-one correspondence between risk and ex post profit and there is no objective proxy for sharing risk equitably except profit. More damaging to the risk-sharing proposition is we shall see the fact that it is not risk but ownership in the product that is relevant to justify the share in distribution of product revenue among the factors of production. The bifurcation of factors into the hired and un-hired ones in Frank H. Knight is irrelevant as a justification for profit going to the latter (entrepreneurs); it is alien to the Islamic thinking. A demonstration takes us to the discussion on some ill-conceived propositions in Islamic finance as under.

A. *The ‘no risk, no gain’ adage*

The 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. The present author had a detailed discussion on the precept in an earlier article (Hasan2004). Its restatement under review tends to rely essentially on evidence extracted from the mainstream sources rather than from earlier reasoning and analysis in Islamic finance. The mainstream literature in economics is so vast and growing so fast that evidence can often be marshalled on either side of the debate on a position – risk sharing included - with impressive documentation. More important 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 impetus to the precept. Some acclaimed writers, working papers from international institutions like the IMF also took cognizance of the notion and attention is now being paid to it even at the level of doctoral research in some educational institutions of repute. Let us examine the logic and tenability of the resurgent precept.

The argument of the ‘no risk no gain’ proponents rests on certain unstated assumptions that call for a closer look. The main ones are as follows.

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6 Chapra (1986) epitomized the mention in the prevailing literature in the adage; See especially Pp 64, 165.
9 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!
B. Capital alone is the factor exposed to risk in production: This assumption is a matter of definition; risk and reward are both pinned to capital investment in the doctrine. 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 pecuniary losses. 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 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 between the providers of capital, there is one even stronger for sharing between labour and capital, especially from Islamic viewpoint.

C. That interest-based finance is entirely risk-free. This is difficult to concede. 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? Is there any worthwhile estimate as to how much risk they transfered 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-bearing, it is of form and degree, not of kind. There may be cases where one can legitimately see risk-transfer in risk-sharing; demarcation need not always be clear.

D. Fixed versus variable payment: 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 because 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. All 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 if both meet the stipulated Shari’ah requirements.

Furthermore, 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 replaces the present conventional arrangement, what shall we use as a reference point to gauge the fairness of profit rate in the economy is not clear? There has to be a base as the sea level in geography for measuring heights.

E. Risk preference versus risk aversion: Last but not the least, the risk-sharin theory assumes that all people or at least all capital owners are venturesome with zero risk-aversion. This is incorrect. And, it is also not true that some people are venturesome while others are risk averse. Risk-taking and risk-aversion are not exclusive categories. Any line of demarcation that one may attempt to demarcate categories would only be arbitrary. The distinction is analytical – the same individual can be venturesome or risk averse depending on his assessment of situation. The difference between people on risk-taking is of degree not of kind and that difference is
circumstantial. Figure 5 clarifies this point. Here the curve \( RP_1 \) shows the possible risk-profit combination having positive relationship. Here the curve \( IP_1 \) shows the possible Risk-Profit combinations having positive relationship. It is convex to the X-axis implying that risk increases at a faster rate than profit as we climb up the curve also, the lower curve \( RP_2 \) promises more profit if risk remains unchanged (point B).

The two IC curves risk-profit indifference combinations. The lower of the two curves is preferable as it shows a lower risk level. Suppose X is in equilibrium at point C the tangency point of \( RP_1 \) and \( IC_1 \). Now if X wants to move to point A you may call him venturesome but if he decides to stay at A he could be dubbed as risk averse. There is no precise measure of risk-aversion – the AB distance. Enterprise and risk-aversion demarcation appears in the Frank H. Knight’s division of production factors into un-hired (entrepreneurs) and the hired ones. Like other factors capital too has the choice to join either of the groups – investors for possible profits or lenders for pre-fixed returns. This is true for Islamic finance as well.

![Figure 5: Risk versus profit in Islamic participatory finance](image)

Mainstream economics regards risk-bearing a service solely undertaken by the capital owners in production; the society rewarding them for that with a payment called profit. Islam does recognize profit as an income accruing to capital but whether or not it is a reward for risk-taking from Islamic viewpoint is questionable. It is argued that risk is neither a commodity which the so-called risk-taker (capitalist) offers to society nor represents labour that he does on some material to claim compensation in the form of wages. Risk is purely a specific mental state that instils in the capital owner the fear of adverse consequences of an action. Two options are open to him:

(i) He must desist from the action if he cannot overcome the fear of adversity, or
(ii) He must conquer his fear and act whatever be the consequence.
Of course he is entitled and must take permissible action to minimize his risks. Risk management is thus an integral part of Islamic finance also.

Mastery over the fear of adversity is a great personality trait psychologically and morally; the society does need such people. But a moral valuation is not the same thing as an economic valuation. Islamic theory of production does not recognize any gain, reward or income as legitimate unless it can be shown to be the result of socially useful contribution to production. As evidence consider the following examples.

**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? For interest is not the result of any productive exertion undertaken by the lender.

**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.

**Pooling individual earnings for sharing:** An extension of the ban on gambling can be seen in the prohibition of pooling individual earnings for sharing. To illustrate, *Shari’ah* would not allow two teachers entering into partnership to take tuition work 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 risk.

**Tools of production:** The tools of production are not allowed to have a share in the profits of a venture on the ground that 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).

**Some other earnings involving risk disallowed:** Certain sources of income (gain) like magic, witchcraft, fortune-telling or jugglery are not allowed 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 through work effort. 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 defence 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 elaborate the 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. Such an attempt would raise insoluble problems. Presumably, the risk-reward connection 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 in business 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 wary of the risks to which limb and life of the workers are exposed. It is palpable that both labour and capital join hands in producing the resultant output; it is the outcome of their combinational productivity\(^8\). 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 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.
5. CONCLUDING REMARKS

This paper aimed at examining the logic and feasibility an old precept recently revitalized in Islamic economics which says that Shari’ah permits no gain unless risk is involved in its earning. It is argued that risk-sharing alone is commensurate with Islamic norms of financing. The increasing is to blamed 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. Thus there is a case it is argued to replace the conventional crisis prone system with the risk sharing Islamic regimen which alone can ensure justice and stability free of crises in modern economies. It is argued that better performance of Islamic banks during the current turmoil compared to the conventional is evidence enough to clinch the point.

This critique of the argument has highlighted its blemishes on juridical and feasibility front to conclude that required is reform of the current arrangements not replacement especially of the inevitability of financial dualism in the global system.

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. A fixed return bench mark is as much needed in financing – conventional or Islamic - as the sea level for measuring heights in geography. 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 levelling the playing field between equity and debt”.

Striking a judicious balance and building appropriate trade-offs between equity and debt is what we need. Replacement has neither logic nor expedience.

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 not the case.

There is dominance of the vested interests and they are vitiating policy implementation leading to non-delivery, at times 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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