Risk sharing versus risk transfer in islamic finance

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Abstract

Some writers on Islamic finance have recently resuscitated the old ‘no risk, no gain’ precept from the earlier literature in the wake of 2007-2008 financial crisis. They argue that the basic reason for the recurrence of such crises is the conventional interest-based financial system that subsists purely on transferring 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 thought as the way to ensuring the establishment of a just and stable crisis free financial system. Islamic banks have faced the current crisis better than the conventional is cited as evidence. The present paper is a critique of this line of thought. It argues that risk-sharing is not basic to Islam. It encourages profit sharing of which sharing of risk is a consequence not the cause. The paper concludes that the case is for reform, not for replacement, of the current debt dominated system marked with duality.

Key words: Financial crisis; Risk-Sharing; Risk-Transfer; Islamic Banking; 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 financing. 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 transformation\(^2\) has led to an increasing reliance on debt financing (Hasan 2014, 19). 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 devastation that 2007-2008 financial turmoil has inflicted on the global economy has provided the proponents of Islamic finance with a fresh impetus to highlight the fallibility of the conventional system and push the divine one, as they understand it, to the fore as a replacement.

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\(^2\) Maturity transformation refers to the use of rolling-over of short-term loan several times to finance long-term needs.
The demonstrations, similar to the one in Mirza et al (2015) that Islamic banks faced the current turmoil better than the conventional, were cited as the evidence; it is not conclusive though (Hasan 2014, 42). The proponents found ‘no risk, no gain’ dictum and discussion on it 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. (Mirakhor 2014, 107).

The statement, taken with the stance of the author on the topic in his other writings, 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 the 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, in our opinion, an indirect role in charting the course that writings on Islamic economics and finance have since taken, and are taking. Section 3 discusses the place of custom in Islam as it follows from the historical background sketched in

3For example, Chapra 1986, 166; and 2014, 248) has been among the initiators of the adage. For its critical examined in recent times see, for example Hasan (2005, 11-12) and Syed Ali in Amer Al- Roubaie and Shafiq Alvi (Editors) Islamic Banking and finance, Routledge 2010, Volume III, 2-3).  
4This paper is largely based on a presentation of Professor Abbas Mirakhor in Kuala Lumpur workshop on the subject in 2012 and a book he co-authored the same year. My reservations on his argument were then expressed in an unpublished working paper: Risk sharing versus risk transfer in Islamic fiancé – An evaluation, available on the site, Zubair Hasan at IDEAS.  
5If 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 2005) but writers reviewing the literature at times fail to appreciate the position.  
6This section draws on Arabia before Islam listed in the references.
Section 2. In Section 4 we explain the relationship between risk and return to 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 additional observations. Sections 2 and 3 may not seem directly related to the issue under discussion but they do provide, we believe, a helpful environmental backdrop for a better understanding of the argument.

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 chief of their tribe. 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 BanuHashim clan including the families of Muhammad, the future prophet, and of Ali ibnAbiTalib, 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 money lenders 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 even 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 (mudaribs) 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. It was an economic institution born of temporal compulsions 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 everywhere.

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 significance 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. They trade their resources for importing mostly consumable goods but little attention is devoted to erecting production capacities even as 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 oil.

Along with many social ills, Islam abolished interest; it promoted ease for loan repayment including extension of time without extra charge. However, the return of the principal stayed holding customary sanctity – the Prophet (pbuh) refused to lead the burial prayer of a dead until someone of those present cleared his debt obligation. This sanctity continues and presumably
accounts in some measure for the tendency among Islamic bankers to merge the return to capital, especially in home financing (Hasan 2013).

*Mudharabah* emerged as an institution for trading as a temporal compulsion, not as an inviolable principle. The position of the financier vis-à-vis the worker (entrepreneur) was weak; he had no choice but to trust the word of the latter. That equation has long reversed; today, the entrepreneurs have to rely on the financiers.

Incidentally, the principle of limited liability, the crux of modern financing arrangements, was all along implied in *mudharabah* contracts although 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 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 see a non-existent parameter as the main cause of arresting development in the post-colonial Muslim world.

Before Islam, slavery too was customary since times immemorial for a variety of reasons including the means for ensured labor supply to run economic activity. The institution was so entrenched that even Islam that abolished such deep rooted practices as interest, gambling and intoxication with no delay, 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 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. However, it has resurfaced in modern society, Muslim included, in some highly abhorrent forms.

The eventual extinction of slavery in general provides an important lesson: However important and well-rooted may a customs be it is not eternal beyond social expedience. Customs must go if they are no longer needed. Islamic history is replete with testimony to this guiding principle. Forms and modes for business activity, finance included, are no exception. Orthodoxy is giving way to modernity in all spheres of life. We have only to look at the change through the Islamic prism to make our choices.

4. RISK AND RETURN TO 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 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 to the rich lenders of the productive assets the poor pawned to get loans was a common happening. 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 decades 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* (1890) could see tiny owner-operated firms dotting an industry and remark that *as it is* with firms in an industry; the trees growing and falling on their own strength while the forest continues to grow. The analogy implied that entrepreneurship and management being unified, the accrual of profit was an issue of little consequence.\(^7\)

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 (Ormerod 2010). But this association gave rise to much infirmity in economic theory as interest also went to the owners of capital. Again, under competitive conditions, profit in the long-run was but “normal” which could hardly be much different from interest. Early classical writers could not provide a basis to separate the two or justify their going to the same functionary – the capitalist. (Knight 1921, 23)

Later day economists, created the distinction between interest and profit by linking profit to risk (Hawley 1893) albeit they did see a profit element in interest associated with risk (Knight 1921). Important however is that Knight nullified all risk theories of profit with a simple argument. Put briefly, the argument 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 – money invested could shrink. Risk of losing money 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 large and 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 (Hawley 1893).

Knight regarded the possession of capital a necessary condition for entrepreneurship as in his view an empty handed person could not guarantee contractual payments to the hired factors of production – land and labor. Interestingly, he does not see any connection between profit and capital. To him, it is a reward for *entrepreneurial services*. The proposition must create problem for the ‘no risk, no gain’ proponents in Islamic finance. For, they do not regard the possession of capital as a pre-requisite for entrepreneurship. On the contrary, their *muḍarīb* is an empty handed worker. However, more damaging to the ‘no risk, no gain’ proposition is Knight’s treatment of risk in his work.

\(^7\)It is interesting that Marshall could experience over time the change in the business environment with reference to the expanding size of firms and the growing intensity of completion. Thus in the last (1924) edition of his *Principles* in the passage on forest quoted above he changed ‘as it is’ to ‘as it was’ with trees in a forest. The forest had converted so to say into a pond – the big fish eating the small one.
He divides risk in two parts – measureable risks and un-measureable risks which he labels respectively as ‘risk proper’ and uncertainty. Measurable risks can be insured at a cost; thus they pose no threat to business and being cost, cannot be a part of profit. The premium paid to the insurer is a charge against revenues like wages or rent the businesses pay. It is uncertainty the un-measurable risk that forces one to peep into the future but what he could see would depend purely on luck or chance. The bifurcation is of far reaching consequence for Islamic finance where gharar or uncertainty has to be avoided. The injunction implies reference only to uncertainty that can be measured i.e. to ‘risk proper’ as defined above.

Unless one is able to refute the logic of the uncertainty bifurcation, risk-management discussions in modern finance – Islamic or conventional – must lose much of their significance. For, measureable risk must be insured; the un-measurable one or uncertainty we have no means to guard against. Beyond what can be insured against at a cost, tawakal – welcoming what Allah may grant, profit or loss –is alone the best risk management tool in Islamic finance. Indeed, the present day risk management does not as it cannot measure total risk due to an un-measurable mix. Risk managers’ measure probable (insurable) loss and to avoid it incur an internal cost possibly higher than the insurance premium.8

Also, the risk-profit linkage we referred to above cannot be shown delivering justice, one of the top priorities of Islamic finance; for, no one-on-one correspondence can be established between risk and profit because of uncertainty affecting both. Furthermore, risk-profit linkage is but ex ante whereas the negotiated sharing refers to a division of ex post profit; no risk is involved. Islam allows sharing of profit (loss) of which risk sharing is a consequence, not the cause.

The contribution of Knight contextual to Islamic finance is twofold. First, he provides a precise definition of what risk is and what it is not. In contrast, the proponents of basing Islamic finance solely on risk-sharing never clarified what they meant by risk or what distinction they make between risk-sharing and risk transfer? And, in what situation one of the two would hold well against the other? Is sharing or transfer of risk to be within the capitalist class or other factors in production should also be participating in sharing? It is such sort of issues that we shall address in the following sections. Second, Knight took note of the rise to dominance of modern corporations that has characteristically changed the risk-profit equation in businesses; especially finance. Capital, organization and entrepreneurship have become distinctly separate entities with reference to their rewards. The bond between profit and risk-taking has much loosened. The appropriation of profit has long become non-functional, not governed by any theory or principle. The proponents of risk-sharing do not seem to have fully imbibed the ramifications of this change and its impact on risk-reward equation.

5. ‘THE NO RISK, NO GAIN’ ADAGE

8There 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).
The present resurgence of risk-sharing is no more than the echo of the ‘no-risk-no-gain’ adage which is ingrained since long in the literature as the sole principle for organizing Islamic finance as noted earlier. The present author had a detailed discussion on the precept in the past (Hasan, 2005, 16-18). Interestingly, the reiteration of the precept under review tends to rely essentially on evidence extracted from the mainstream sources rather than from earlier Islamic finance literature. The mainstream writings in economics are growing fast and the literature is so vast that evidence can often be marshaled on either side in a debate, including risk-sharing, with impressive documentation.\(^9\) Important, however, is to examine the logic behind a theoretical proposition.

The risk-sharing precept got currency in Islamic 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 lull 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:

\[ \text{Allah hath permitted trade and forbidden usury.} \]

(Translation Yusof Ali Abdullah)

The verse ordains that all economic and financial transactions are to be conducted through contracts of exchange (\(al-bai’\)) 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 because interest shifts the risks of financial transactions to the borrower. It is argued that exchange being the characteristic of sale allows the risk of transactions to be shared (Osman & Mirakhor 2014, P.65 emphasis added).

Now, 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 allows i.e. does not insist on risk-sharing being a necessary condition for a valid contract. \(Al\ bai\) in its generic sense encompasses all contracts whereby a given quantity of one commodity or service is exchanged for a given quantity of the other, including money, unless forbidden by the 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 (istikna) or leasing (ijara) are the leading examples. Such transactions do involve risk but the result of the contract is risk-taking, not its sharing, we shall argue.

Again, the implication of the precept that capital alone is the factor exposed to risk in production is not valid: It is free markets doctrine that pins both risk and reward to only capital

\(^9\) 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!
investment while 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 providers of capital, there is one even stronger for such sharing between labor and capital, especially from Islamic viewpoint (Hasan, 1983).

A further assertion of the ‘no risk, no gain’ proponents that interest-based financing is entirely risk-free - the risk is transferred to others - is again untenable. We have quoted Knight above as seeing a risk element in interest as well. It is common knowledge that the discounted cash flow model treats the future expected cash flows by discounting them over time at a rate which is commonly the return on an alternative investment with the same level of risk. 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? Is what capital faces in deferred payment Islamic contracts 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 at times involve its transfer. There could be cases as sleeping mudharabah where one can see partial risk-transfer in the garb of 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. In Islamic finance the service charge is called profit, in conventional interest. 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, uncertainty and profit in 1957, the corporate form of business organization had risen to dominance, the personality of the classical entrepreneur had disintegrated decision-making became scattered throughout the managerial hierarchy and competition had become increasingly intense. What remained intact of Knight’s 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 desist, or
(ii) He must conquer his fear and act and take whatever be the consequence. 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. One takes the post price risk out of his own sweet will; it does not arise in the course of spot sale and purchase. Pecuniary gains also 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, for the reason that 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 labor 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 are 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.

6 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. Knight’s uncertainty theory reduced profit to windfall gains of little significance. 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”.

To us, the risk-reward equation is grossly misleading. 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 narrow mundane view of things to their broader cosmic import in their economic explorations without notice or forging a link between the two scenarios. To us, a possible link seems to be in interpreting cosmic as application of the Divine intent to the totality of human existence, the populace. If this view is acceptable, risk-sharing must be applied in all walks of life not to business capital providers alone as indicated earlier.

To reiterate, at the micro level: the labor-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 labor and capital join hands in producing the resultant output; it is the outcome of their combinational productivity. Its customary division between profit and wages is arbitrary unless labor gets a share in profit subject to a minimum wage constraint (Hasan 1975). 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 which leaves some crucial questions unanswered: Would mainstream finance that rests 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, let alone risk-sharing? We believe that it is not a case of risk-sharing or risk-transfer; it is a case of building appropriate bridges between the two systems - conventional and 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 risk 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 in its earning. It is argued that risk-sharing alone is commensurate with Islamic norms of financing. The increasing recurrence of financial crises is 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. 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 in equity financing. 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 endeavor to move away from interest-based systems towards enhancing risk-sharing systems by leveling the playing field between equity and debt”.  

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.” (Sami 2014)

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

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10 Many classical jurists have indeed classified mudharabah as ijara-bil-gharar - hire with uncertain wage (if uncertainty is excessive) The contract may even include an element of riba if the profit share of the mudarib is not fair, that is commensurate with the work done, fairness being determined by the market wage for similar work. (El-Gamal 2014).

11 It is notable that in their moiré recent writings the proponents have given up their this-or-that approach to the financing instruments and that itself liquidate their earlier approach to the issue.

12 Presumably, the exclusivity has no historical evidence as well even though Murat Cizaca a noted historian of Islamic finance writes: “Thus, it follows that Islam prefers risk sharing to risk shifting”. 

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economic benefits or obeying religious imperatives worldly concerns tend to overweigh the hereafter considerations even among the pious.  

The proponents of making risk-sharing the sole basis of Islamic finance should re-evaluate the Shari’ah base of their argument. In any case, risk-taking is not the same thing as risk-sharing. They should evaluate the feasibility of their suggestions including for erecting a new stock exchange that they think would enable equity-based financing replace debt-based instruments like sukuk that has become well-entrenched in the system and dominates it. (Rudnyckyj, 2014, 123). For, speculation and prediction are, as it has to be, typical of all stock markets.

Notably, the present is an era where rightly or wrongly no proposition is acceptable unless it passes the litmus test of empirical verification. One is not sure if any variable is available or can legitimately be coined to capture risk-sharing.

Finally, it is interesting to note that proponents of risk-sharing regime for Islamic finance have of late shifting their position to abandon the exclusivity of their proposition; they admit that debt-based Islamic finance instruments are Shari’ah compliant and are required for the successful operation of the system. With this admission, how much is left of their ‘solely and only’ stance on risk-sharing intact, the readers must ponder.

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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13 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.”

14 The distinction is important because the proponents of risk-sharing may possibly be relying on the Islamic legal maxim: Benefit goes with liability. However, there are various interpretations of the word ‘liability’ in Islamic jurisprudence but none makes risk-sharing an imperative for Islamic finance. (See ISRA 2013, 156-160)

15 See, for example, Osman and Mirakhor (2014b) as also Chapra (2014).
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