Risk sharing versus risk transfer in Islamic Finance: A critical appraisal

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RISK SHARING VERSUS RISK TRANSFER IN ISLAMIC FINANCE: A
CRITICAL APPRAISAL

Dr. Zubair Hasan*

Abstract

Some writers on Islamic finance have recently resuscitated the old ‘no risk, no gain’ precept from the earlier literature in the wake of the 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 based on the transfer of risks. In contrast, Islam shuns interest and promotes the 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, stable and crisis-free financial system. As evidence to support this thesis, it is cited that Islamic banks have faced the current crisis better than their conventional counterparts. The present paper is a critique of this line of thought. It argues that risks sharing is not basic to Islam. Islam approves profit-and-loss sharing; sharing of risk is a consequence of that, not its cause. There is no such thing as a risk-sharing contract per se in Islamic finance that, when entered into, gives rise to profit-and-loss sharing. The paper concludes that while there is a case for encouraging participatory finance in Islam, there is none for treating risk sharing as its inviolable principle. What really requires emphasis is the need for transparent moral conduct and commitment to Islamic ethical norms.

Keywords: Financial crisis, Risk sharing, Risk transfer, Islamic banking, KL Declaration.

1 INTRODUCTION

The devastation that the 2007-2008 financial turmoil has inflicted on the global economy has provided the proponents of Islamic finance with a fresh opportunity to highlight the fallibility of the conventional system and promote 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 proponents of Islamic finance accordingly found the discussion on the ‘no risk, no gain’ dictum still relevant to the current context, for Islam shuns interest and promotes the sharing of risk, not its transfer to the counterparty. The revival of risk sharing is not basic to Islam. Islam approves profit-and-loss sharing; sharing of risk is a consequence of that, not its cause. There is no such thing as a risk-sharing contract per se in Islamic finance that, when entered into, gives rise to profit-and-loss sharing. The paper concludes that while there is a case for encouraging participatory finance in Islam, there is none for treating risk sharing as its inviolable principle. What really requires emphasis is the need for transparent moral conduct and commitment to Islamic ethical norms.

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1 For example, see Chapra (1986: 64, 166) for an earlier projection of his position on the concept of ‘no risk, no gain’, which he reiterated in (2014: 248). For a critical examination of the proposition, see Hasan (2005: 11-12).
sharing in Islamic finance is led by Professor Abbas Mirakhor and has been a major theme of discussion in his lectures and writings. Mirakhor (2014: 107) states his position as follows:

Practitioners grounded in conventional finance, however, were interested in developing ways and means of finance that, while Sharīʿah-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 Sharīʿah compatibility, a somewhat regrettable process.

The observation, along with statements on the topic in his other writings, forms the basis of his following convictions:

- That the world’s financial system is inherently prone to instability and financial crises since it works *solely* through the system of transfer of risk, not through its sharing; and
- That the Islamic financial system—which allows *only* risk sharing, not its transfer—is the only one that can pull the world back from the brink of disaster.

These propositions, coming from a senior academic and practitioner, carry far-reaching policy implications for the future of Islamic finance with regard to its substance and direction. That the interest-based conventional system of finance is fragile and unstable is an established fact. That equity is better than debt as a source of finance is also not in dispute. The difficulty with the above propositions essentially is with their ‘solely’ and ‘only’ aspects. This paper presents a preliminary evaluation of the propositions focusing on these aspects. To that end, Section II briefly explores the relationship between risk and return to capital. Section III examines the proposition that Islam allows *only* the sharing of risk as basis of financing. Section IV extends the critical appraisal of the proposition. Finally, Section V concludes the argument of the paper with a few additional observations.

**II. RISK AND RETURN TO CAPITAL**

The adage ‘no risk, no gain’ presumes an unbreakable linkage between risk and return to capital. The question is whether this presumption is valid. Initially, the association of risk with return emerged to justify the charging of interest on loans largely taken to meet basic survival needs or to perform social rituals (Rubin, 2011: 1313). The flow of money was from the rich to the poor in society. The

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2 This paper is largely based on a presentation of Professor Abbas Mirakhor in a Kuala Lumpur workshop on the subject in 2012 and on Mirakhor, Askari and Krichene (2012). My reservations on his argument then were presented in an unpolished paper titled *Risk-Sharing versus Risk-Transfer in Islamic Finance: An Evaluation*.

3 If the participatory financing and the debt-based instruments that dominate Islamic finance are both Sharīʿah-compliant, the proponents of ‘no risk, no gain’ dictum must discover why the former are not and could not be made popular in the modern application of Islamic finance. It is a fact that no industry can rely solely on the fiat of the government, much less to please the scholars, unless conditions conducive to its development are created. A few writers, including the Governor of Bank Negara Malaysia (BNM), have lamented this deficiency.
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 a common occurrence. The emergence of grinding poverty and abhorrent distributional inequalities of wealth and incomes were the consequence. However, commercial lending grew rapidly with the passage of time.

Indeed, the bulk of the loans in Arabia were for commercial purposes when Islam made its advent on the scene (Chapra, 1986, 64). But during the early decades of industrial expansion (1775-1825), men normally used their own capital in dominant industries, hiring labor and renting land and tools from others. The managerial function centered on the capitalist, and competition was moderate. Thus, Marshall in his Principles of Economics (1890) could see tiny owner-operated firms dotting an industry and remarked that they would grow and fall on their own strength, just as trees do while the forest continues to grow. The analogy implied that the issue of profit appropriation was then of little consequence, with entrepreneurship and management forming a single entity.

During this early era of industry, the income of the owner-manager naturally got linked with capital. In all the classical writings, the word ‘profit’ is found to be used in this sense (Ormerod, 2010). However, this association gave rise to much confusion in economic theory as interest also was attributed to the owners of capital. Early classical writers could not provide a basis to separate the two or justify their attribution to the same functionary, the capitalist (Knight, 1921: 23).

Latter-day economists created the distinction between interest and profit by linking profit to risk (Hawley, 1893), albeit they still saw an element of risk remaining associated with interest (Knight, 1921). Importantly, however, Knight nullified all theories relating profit to risk. He did so with a simple argument which briefly runs as follows. Under perfect competition where participants in production have, by assumption, complete information of the market and enjoy perfect mobility, economic profit must be zero; for normal profit that the firms get is treated as an element of cost. The return to capital must be identical with the risk-free interest rate. Dynamic change that cannot be foreseen, however, makes competition imperfect, and business ventures become risky—thus, money invested could shrink. This fear of losing money divides society into two sorts of people. Most people prefer to have assured incomes rather than face uncertainty. For, such assurance is available if they are willing to work for others. This is possible for, in fact, there are some others in society who are willing to derive their income by engaging in businesses in which they expect to earn higher incomes as profits. Accordingly, risk divides society into the hired and un-hired factors of production, the latter being the entrepreneurs who are risk takers and earn profit, and the former the workers who wish for employment and seek secure fixed incomes. Thus came into vogue the residual claimant theory of profit for rewarding entrepreneurial work in Hawley (1893).

Knight (1921) regarded the possession of capital as a necessary condition of entrepreneurship for, in his view, an empty-handed person could not guarantee contractual payments to the hired factors of production—land and labor. Interestingly, he did not see any connection between profit and capital. He considered profit to be a reward for entrepreneurial services. The proposition must create a problem for the ‘no risk, no gain’ proponents in Islamic finance for they do not regard the possession
of capital as a prerequisite for entrepreneurship. On the contrary, the *muḍārib* (entrepreneur) in a *mudārabah* (partnership) contract is an empty-handed worker. However, more damaging to the ‘no risk, no gain’ proposition is Knight’s treatment of risk in his seminal work.

He divides risk into two parts—measurable risks and unmeasurable risks. He labels them 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 that businesses pay. It is uncertainty, the unmeasurable risk, which forces one to worry about future outcomes that depend purely on luck or chance. The bifurcation is of far-reaching consequence for Islamic finance in that *gharar* (uncertainty) must be avoided. The prohibition of *gharar*, we believe, refers to that which can be measured, i.e., to ‘risk proper’ only.4

Unless one is able to refute the logic of the uncertainty bifurcation in Knight (1921), risk management discussions in modern finance—Islamic or conventional—must lose much of their significance. That is because measurable risk must be insured while we have no means to guard against unmeasurable risk or uncertainty. Beyond what can be measured and insured against at a cost, *tawakkul* (relying on what Allah may grant, profit or loss) alone is the best risk management tool for Islamic finance. Indeed, the present day risk management system cannot measure total risk due to the possible existence in it of an unmeasurable component. Risk managers measure probable (insurable) loss and, to avoid it, incur an internal cost possibly higher than the insurance premium.

Also, the risk-profit linkage we referred to above cannot be shown to deliver justice—one of the key priorities of Islamic finance; for no one-to-one correspondence can be established between risk and profit, with uncertainty affecting both. Risk resides in the future, as does possible loss, its adverse consequence. In participatory finance, what the contracting parties agree to share is ex-post profit, for the loss, if incurred, must fall by default on capital. Thus, sharing ratios relate to ‘after the event values’ not to ex-ante risk or loss estimates. Let one also not forget that there are several alternative methods for risk estimation, and there is no agreement on which of them is the best and under what circumstances (NYU.edu, 2014).

Furthermore, risk sharing is a unidirectional concept focusing on loss alone; it has nothing to do with the emergence or quantum of profit. As mentioned above, there is no one-to-one correspondence between profit and risk. Thus, approaching financial issues from the risk end may not be commensurate with the equity norms of Islam. Even striking a just balance between individual losses of the parties may not be possible. To illustrate, take the case of a pure classical *mudārabah* where the *muḍārib* is an empty-handed person, the financier providing all the investment money. Under adverse results, it is argued that if the financier gets shrinkage in his capital the *muḍārib* suffers a fall in his reputation. Granted, but if there is, say, 10% shrinkage in capital, none can be sure that there will be an identical shrinkage in the *muḍārib*’s reputation? Are the two losses comparable?

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4 There is a fundamental difference between the reward for taking a known risk and that for assuming a risk whose value 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, 1921).
Finally, the positive incentive for people to invest in business is the expectation of profit, not the fear of loss. Let scholars as well as practitioners approach financing issues from the optimistic positive end—that of profit sharing—rather than from the end of perilous sharing of risks. It has been demonstrated that debt contracts are characterized by larger financial access than the sharing contract (Nabi, 2013: 26). Debt-like contracts that Islam allows are promotive of investment and growth. Focusing on risk sharing would also raise the issue of its linkage with risk aversion, leading the discussion farther into the barren lands of mathematical abstractions (NYU.edu, 2014). Such abstractions have little operational value.

The contribution of Knight (1921) is twofold in the present context. First, he provides a precise definition of what is risk and what is not. The proponents of risk sharing lack clarity on this point, though they differentiate well between risk sharing and risk transfer. A bigger issue is whether sharing or transfer of risk is an issue among the capital owners only or should other factors in production also participate in the sharing? Such sorts of questions remain unanswered.

Second, Knight (1921) took notice of the rise to dominance of modern corporations that have changed the risk-profit equation in businesses, especially regarding finance. Capital ownership, management and entrepreneurial functions have become separate and distinct entities. The bond between profit and risk taking has loosened considerably. The proponents of risk sharing do not seem to have fully imbibed the ramifications of the great transformation and its impact on the risk-reward equation.

The organizational structure underpinning the advocacy for risk sharing in Islamic finance is that of the classical proprietary or partnership businesses while in the modern corporations that dominate the business scene the classical entrepreneur has long become a disintegrated heuristic entity. The following table is revealing on this point, even though the data is not very recent. Table 1 shows that the largest revenue and profits are generated by the modern corporation, even if the number of sole proprietorships is far higher.

<table>
<thead>
<tr>
<th></th>
<th>Number</th>
<th>Revenue</th>
<th>Profit</th>
</tr>
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<tbody>
<tr>
<td>Sole Proprietorship</td>
<td>72%</td>
<td>5%</td>
<td>16%</td>
</tr>
<tr>
<td>Partnership</td>
<td>8%</td>
<td>8%</td>
<td>15%</td>
</tr>
<tr>
<td>Corporation</td>
<td>20%</td>
<td>87%</td>
<td>69%</td>
</tr>
</tbody>
</table>


The situation was not much different in developing economies, such as the Indian Subcontinent, as early as the 1970s (Hasan, 1975). It is time that Islamic finance gurus leave aside the obsolete *muḍārib-rabb al-māl* stories and adjust their thought process to the current realities and temporal demands; Sharīʿah is sufficiently flexible to accommodate beneficial change.
III. OLD WINE IN NEW BOTTLES

The present advocacy of risk sharing as the sole principle of Islamic finance is not a breakthrough of any sort; it is just the echo of the ‘no risk, no gain’ adage long enshrined in the literature as its sole principle. The present author discussed the adage in detail in an earlier article (Hasan, 2005: 16-18). Interestingly, its reiteration under review tends to rely essentially on evidence extracted from mainstream sources rather than on earlier writings on the subject in Islamic finance literature. The mainstream stock in economics is growing fast and is so vast that impressively documented evidence can often be marshaled on either side in a debate, including risk sharing. It is important, however, 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 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’ānic verse (2:275) which in the relevant part declares:

“Allah has permitted trade and forbidden usury.”

Halim (2001) quotes lavishly from three of the leading commentaries on the Qur’ān—Ibn al- ‘Arabī, al-Qurṭubī, and al-Jaṣṣāṣ—to explain at length the meaning of al-bay‘ and al-ribā and the issue of their permissibility or otherwise in the light of the above verse. In conclusion, he makes the following observations.

1. The term al-bay‘ in its generic meaning encompasses all types of exchange contracts except those forbidden by the Sharī‘ah.

2. Al-bay‘ means any contract of exchange whereby a given quantity of a commodity or service is exchanged for a given quantity of another commodity or service.

3. The delivery of the commodity or service on the part of each party to the contract may be simultaneous, i.e., on the spot, or one of them—not both—may defer the discharge of his obligation to a future date.

4. The term al-bay‘ thus encompasses many types of deferred contracts of exchange including salam sale (bay‘al-salam), sale on order (bay‘al-istiṣnā‘), and leasing (al-ījārah).

Furthermore, the term al-ribā, as used in the verse under reference, means to him what has come to be known in fiqh as ribāal-duyūn, i.e., additional consideration imposed by the creditor on the debtor.

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5 The classification of the notes and references in one such study of repute included in the references confirms the generous borrowings from the mainstream sources; some even from the heterodox literature. The bibliography contains some 325 entries. Only 75 of these are from writers on Islamic finance. Of the 75, no less than 40 belong to the writers of the book. Thus, for the criticism of the mainstream positions too our scholarship essentially draws on the mainstream itself!
as an inducement for the former to extend the deferred liability period. It is not allowed due to the absence of a compensatory counterpart in real terms. Halim (2001) claims that the three commentaries he refers to are unanimous on this interpretation of the verse.

This much, we believe, even the proponents of risk sharing would not dispute. The difficulty is that their further insistence 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 a sale does allow the risk of transactions to be shared, but it does not make such sharing obligatory.

One should be clear that *ribā* is banned not because it transfers risk to the borrower but because the lender offers no compensatory value for it in real terms. 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 (*istiṣnā*), or leasing (*ijārah*) are the leading examples. Such transactions do involve risk, but we shall argue that the result of the contract is risk taking, not sharing.

Again, the presumption that capital is the only factor exposed to risk in production is not valid: it is a part of the free market doctrine, which pins both risk and reward only to capital investment while ignoring the risk that human beings face while working in various sorts of production, even though such risks could be more persistent and damaging to life and limb than loss of money. Men, women and children working in coal mines, cement factories, on oil platforms in open seas, at nuclear reactors or even controlling traffic at crowded road crossings face hazards no amount of money can compensate. During cyclical ups and downs, whether capital or workers suffer more depends on the terms of the contracts that govern their employment. If there is a case for risk (and profit) sharing among the providers of capital, there is an even stronger case for sharing risk (and profit) between labor and capital, especially from the Islamic viewpoint (Hasan, 1983).

A further assertion of the ‘no risk, no gain’ proponents that interest-based financing is entirely about risk transfer and therefore risk free for the lender—is again untenable. Conventional lenders do face risks of default regarding the principal and/or interest. Furthermore, the 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?

Furthermore, 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 the conventional risks, and mortgages provide cover in both cases. If there is a difference between equity and debt with reference to risk, it is of degree, not of kind. Interestingly, sharing of risk may involve its transfer. There could be cases, as in sleeping *mudārabah*, where one can legitimately see risk transfer in risk sharing.

Finally, another distinction the proponents make relates to the fixity versus variation of payments with regard to interest and profit. It is argued that fixed return to capital is not allowed in Islam; even
its use as a benchmark is questionable in some forums. However, this is only partially true. Islam does allow a time value to money as part of the price in deferred payment contracts based on murābahah (cost plus an agreed fixed margin financing mode). Deferred payment 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 predetermined returns on the other if both meet the stipulated Shari‘ah requirements.

IV. BASIC CRITICISMS

Knight (1921) was categorical that profit is not a return to capital; it is a reward for entrepreneurial services—primarily relating to direction and coordination of the business. 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, as alluded to earlier, had disintegrated, decision making had become 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 such a person; for example, the capital owner:

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

(ii) He must conquer his fear and act and accept whatever be the consequence. Risk taking is purely discretionary for humans. For that reason Islam neither promises a reward to a risk-taker nor 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 is out of one’s own free will; it does not arise in the course of the spot sale and purchase transaction. Pecuniary gains arise, devoid of risk, in the form of wages or rent for contributing to the permitted productive effort.

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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 was reduced to a windfall profit/loss case of little significance as probability-based instruments cannot predict or measure them (Hasan, 1975, 1983).
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 does Islam ban interest? Simply for the reason that interest is not the result of any productive exertion undertaken by the lender to earn it.

3. **Ban on gambling:** Like interest, Islam prohibits gambling and earnings based on it, albeit gamblers take great risks and are even ruined at times. The reason again is that labor in gambling is unproductive of real goods. The ban on gambling also extends to the sharing of a pool of individual earnings. To illustrate, the Sharīʿa would not allow two doctors entering into partnership to take patients separately but pool their earnings to be shared in a pre-agreed ratio. This is to avoid the 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. (Baqir-as-sSr 1984, 78)

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 production process. But tool owners are not denied a return; they gain in the form of fixed returns (rentals). However, Hanafis allow the tools as part of capital contribution provided their monetary value is agreed upon at the start of production.

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.

All these and the like are ways of illegitimately consuming one another’s wealth as no trade with mutual consent is involved (Qur’ān, 2:188; 4:129). Even though risk may be involved, gain/profit may not be legal. The permissible way of generating profit and its sharing is allowed in all cases where participants can be shown as contributing to socially useful production.

Consequently Baqiral-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 *mudārabah* 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 *mudārabah* 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 fulcrum of Islamic finance to the exclusion of other permissible modes of financing, one must take an extended view of risk and show its applicability in various socioeconomic conditions as harmonizing with the Islamic norms of justice. An attempt to do so has to be comprehensive and complete to avoid raising insoluble problems. This would be a palpably horrendous task not worth the effort.

We find the risk-reward equation 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 transfer of the commodity to the market for ready availability to the consumers, for he continues to remain its owner (al-Sadr, 1984: 75-76).

At times the proponents of risk sharing switch over from a narrower argument to the cosmopolitan plane in their explorations without notice and without forging a link to their narrower discussions of human existence. To us, the link lies in extending the applications of the principle to outer social realities.

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

If conventional banks could indeed have shifted their risk to clients in the current crisis, the clients alone would have suffered. The fact that mighty banks fell apart was only proof that they had taken excessive risks, i.e., beyond their capacity. In the same way, participatory finance in Islam entails the shifting of risk partially to the depositors. Calling it risk sharing or shifting is a matter of discretion, not of principle.\(^7\) The exclusionist approach of the risk sharing advocates alluded to earlier is all the more worrisome. Crucial questions remain unanswered; for instance, would the mainstream financial system, which rests on the institution of interest and is blamed for risk shifting, allow—let alone welcome—its replacement with the Islamic, given its global reach and dominance? Moreover, can Islamic finance survive purely on risk taking? Such questions call for more serious thought and wider discussions. Candidly, it is not a case of one system replacing the other; it is a case of building appropriate bridges across the two—conventional and Islamic. One feels that the proponents’ approach is not only exclusionist but may also prove isolationist.

\(^7\) Many classical jurists indeed classified mudārabah as ijārahī al-gharar, giving an uncertain wage to the worker. The contract may even include an element of ribā, if the profit share is not commensurate with the work done, fairness being determined by the market wage (El-Gamal, 2014).
V. CONCLUDING REMARKS

This paper aims at examining the logic and feasibility of an old precept whose revival in Islamic finance has recently been sought. Its advocates maintain that the Sharīʿah permits no gain unless risk is involved in its earning. It is further argued that risk sharing alone is commensurate with Islamic norms of financing. They blame the increasing recurrence of financial crises on interest-based finance because it promotes, they say, the transfer of risks, not their sharing. They argue that Islam bans interest and allows only the sharing of risks in financing, not their transfer. This critique has highlighted the unacceptability of this line of argument on both the juridical and feasibility fronts.

Interest-based financing is not altogether devoid of risk taking; nor are all transactions in Islamic finance based on risk sharing in the same way as it is shared in the case of conventional equity shares. 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 the ‘no risk, no gain’ precept cannot be defended as an exclusive principle of Islamic finance. Risk is not a tradable commodity; nor is it an act contributing to the value of output. Many transactions involving risk are not allowed while many transactions not involving any risk are. The principle of sharing of profit and loss is valid, but its basis is not the existence or absence of risk.

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 Islamic Development Bank (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 (Suwailem, 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 is

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8 It is notable that in their more recent writings the proponents have given up their exclusivist approach to the financing instruments, which liquidates their earlier approach to the issue (see, for example, Osman and Mirakhor, 2014, and Chapra, 2014).
unfortunately not the case. When confronted with the choice of reaping economic benefits or obeying religious imperatives, worldly concerns tend to outweigh the Hereafter consideration.

The proponents of making risk sharing the sole basis of Islamic finance should re-evaluate the Sharīʿah basis of their argument. It may contextually be noted that risk taking is not the same thing as risk sharing. They should evaluate the feasibility of their suggestions, including the establishment of new stock exchanges that they think would enable equity-based financing (in the form of ṣukūk) and replace debt-based instruments. For, speculation and prediction is, as it has to be, typical of all stock.

Also, we have to remember that in the present era of research in economics, econometric modeling, rightly or wrongly, dominates the scene. If one has to test for the relative efficacy of risk sharing and risk transfer, it is fuzzy as to what variables could capture each of these expressions for the model, and could remain free of internal conflict. In any case such models cannot deal with the totality of risk that banks face; they would deal with its measurable truncated part.

Last but not the least, this paper neither opposes risk sharing nor seeks to mitigate the need for risk management. It is interesting to find that the proponents of the risk sharing regime for Islamic finance have been, of late, shifting their position to abandon the exclusivity of their propositions; they admit that debt-based Islamic finance instruments are Sharīʿah compliant and are required for the successful operation of the system (see footnote 8). With this admission, one wonders how much of their ‘solely and only’ stance on risk sharing remains intact?

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

References


9 Malik et al (2011: 45) make an interesting point on risk sharing referring to ṣukūk. They say, “Islamic investors are supposed to be justified by risk sharing, the notion of taking on each other’s burden. With ṣukūk, 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.”


