

Does Shari'ah Encourage Risk Taking?

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There have always been conflicting views about the extent of risk that Islamic banks need to assume. For some people, they presume that risk is desirable and is an essential element to justify earnings for Islamic banks. This group of people places great emphasis on risk and liability that Islamic banks must take in order to achieve the Islamic economic objectives, including social justice, equitable distribution of income and promoting the ideal way of practicing Islamic finance. They rely upon the popular Islamic legal maxim *Al-Ghunmu bi Al-Ghurmi* (profit bears risks) to support their assertion.

Is it true that risk is desirable and praiseworthy in Islamic finance? If yes, can we use hedging instruments in Islamic finance then? If the opposite is true, then to what extent risk is considered inevitable to justify earnings as pronounced by the Islamic legal maxim mentioned above?

Legal Maxims in Islamic Finance

Before we answer the above questions, let us examine the Islamic legal maxim mentioned earlier. In Shari'ah, *Al-Ghunmu bi Al-Ghurmi* is one of the important legal maxim that establishes the legality of any return or profit earned in commercial transaction. The maxim is originally taken from the *Majallah al-Ahkam al-'Adliyyah* (the civil code of the Ottoman Empire). The compilation of the civil code is based on Islamic



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jurisprudence principles. The civil code comprised of 851 articles and this maxim was mentioned under Article No.87.

Another similar Islamic principle is *Al-Kharaj Bi Al-Dhaman*, which means that entitlement to profit or gain depends upon the corresponding liability for loss. This implies that if a person has no liability for bearing a loss in a transaction, he cannot enjoy the profits arising from such a transaction. Hence profit has to be earned by sharing risk and reward over ownership through the pricing of goods, services or usufruct of goods.

Both of these principles are derived from a number of hadith. The first hadith was reported by 'Aisyah r.a. who said: One day a man bought a slave and freed him before realising that there was a defect on the slave. He then returned the slave to the seller. The man then brought his case to the Prophet s.a.w. and said: "Indeed, I have freed my slave". The Prophet s.a.w. replied: "Al-Kharaj bi al-Dhaman" which means entitlement to gain bears liability (Ibn Majah). Another similar hadith was narrated by Abdullah ibn Amr in which he said: "The Prophet s.a.w. has prohibited a gain (*ribh*) without assuming liability (*dhaman*)" (Tirmizi).

What risks are inevitable?

The scholars unanimously agreed that a buyer has the right over any defective goods sold to him based on the principle of *khiyar al-aib* or option of defect. This is the liability that a seller needs to assume when selling good or usufruct to buyer. Such liability justifies any gain derived from the sales transaction.

The above legal maxim has important implications for various transactions. In a loan transaction, there is no entitlement to any profits because the creditor gets back the full amount, irrespective of the outcome of debtor's business venture. In trade transactions, the seller is entitled to the profit from the sales price because he has to bear the risk of ownership and assume liability for loss when the subject-matter has actually moved into his possession before selling it to customer. Similarly, in *Ijarah*, the lessor is entitled to rent only when he keeps the asset in usable form by incurring ownership-related expenses and undertakes the risks associated with the asset. In *Mudarabah* and *Musarakah*-based investments, investors' earnings depend on the result of economic activity

undertaken by the venture, and they will share the profits as per the agreed ratios and bear the loss as per the share in the capital of the business.

Therefore, risk is legitimate when it is necessary for value creation. In fact this type of risk is inevitable since it is inseparable from real and value-adding transaction as transpired in the legal maxim mentioned earlier. This is also consistent with the general principle of Islamic finance to be always linked to real transactions. In this regards, any attempt to deliberately separate risk from ownership and thus from real activities, may appear in direct opposition to Shari`ah principles.

Illegitimate risk?

Not all risk are legitimate from Shari`ah perspective. Risk is illegitimate when it involves gambling or any form of zero-sum game. The characteristics of zero sum game may take various forms. First, in any zero-sum game, uncertainty at the time of contract is an essential condition. Otherwise the game would not have taken place. Second, an actual transfer of wealth takes place without counter-value (*'iwad*) in exchange. What happens is that, one party gains while another party loses. For this reason the Prophet s.a.w. has put further conditions on normal sale, whereby one cannot sell before taking possession or sells what one does not have. This is to ensure that the transfer of wealth takes place with clear counter-value in exchange such as profit versus liability and risk.

Even though bearing of risk is somehow connected to the legality of earnings, it does not mean that risk is something which is always desirable from Islamic perspectives. If risk is defined as possibility of loss, then it becomes clear from an Islamic

perspective that such risk is not desirable. In fact, exposing wealth to unnecessary loss is clearly against the objectives of Shari`ah (*Maqasid as-Shari`ah*) which among others aims at protecting and preserving wealth. Many Quranic verses and hadith of the Prophet s.a.w. substantiate this objective.

According to Dr. Sami al-Suwailem in his book, *At-Tahawwut fi al-Tamwil al-Islami*, risk that reflects hardship is not desirable. He quoted Ibn Taimiyyah in his *Majmu' Fatawa* who states that: *"Reward of deeds is based on their usefulness, not their hardness. A good deed might be hard, but its goodness is for a reason other than being hard. Reward may be larger if involved larger hardship, not because hardship is the objective of the deed, but because the deed implies hardship"* (Ibn Taimiyyah; pp.10:620-622)

Is risk mitigation permissible?

Not all risks can be mitigated or avoided. Risk that is naturally embedded in Islamic contract, value-added in nature and connected to the real economic transaction is inevitable and hence cannot be mitigated. On the other hand, risk that can cause hardship and may jeopardise wealth can be mitigated insofar it is related to real economic transaction and does not in any way invoke the issue of gambling or zero-sum game.

However mitigation of the risks would require special expertise and sound knowledge of Shari`ah rules, otherwise it may lead to non-Shari`ah compliance. Islamic parameters identify responsibilities/liabilities of the parties in respect of every contract and one cannot avoid nor mitigate that responsibility/liability.

Islamic banks can manage and mitigate risk only to a certain limit. Beyond this they will have to assume the risk/loss. For example, in car financing based on *Ijarah Thumma Al-Bay'* (AITAB) contract, the bank can put a penalty clause in the contract to serve as a deterrent in order to mitigate the default risk. However the bank cannot ask the lessee to bear the risk of asset loss (not due to any negligence of the lessee) in addition to paying the rent. Here the bank will have to bear the cost of managing the risk, although it can build such costs into rentals with the free and mutual consent of the lessee and subject to related juristic rules.

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In conclusion, Islamic banks are allowed to manage and mitigate risk as long as it is within the ambit of Shari`ah. Hence risk can be mitigated but not totally eliminated. Transfer of commercial risk to anyone else without transferring the related reward is not permissible. Reward should depend on the productive behaviour of the business where funds are used, implying that interest, lotteries, gambling etc. are prohibited because return in respect of them either does not assume the business risk or is based on pure luck, chance and hazard.