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ISLAMIC FINANCE AND THE CONCEPT OF PROFIT AND RISK SHARING

Fatemah A. Al Maddah
Legal Advisor, Jeddah, Saudi Arabia
E-mail: fatmah.almaddah@gmail.com

ABSTRACT

Purpose: This paper introduces Islamic partnership structures as an alternative to conventional debt contracts. It specifically addresses the situation of entrepreneurs seeking funding from banks. The Islamic principle of profit and risk sharing, emphasised in Islamic partnership structures, is discussed in detail as it replaces the phenomenon of risk transfer present in most conventional financial and banking products. This paper explores two of the commonly used Islamic partnership structures; the *Mudarabah* and *Musharakah* structures. The paper explains how these structures benefit the financiers as well as entrepreneurs as both parties share in the risks and profits of the enterprise and hence both their interests are aligned. In addition to the financial and economic impacts of the principle of profit and risk sharing, the paper explores its important role in achieving socio-economic justice.

Design/Methodology/Approach: The paper is developed based on the secondary sources and literature review.

Findings: The paper concludes that Islamic partnership structures aim at incentivising the bank and the entrepreneur to cooperate with each other to increase their wealth and avoid losses and they can hence minimise the disadvantages of conventional interest-based debt contracts.

Originality/Value of the paper: The paper assists the entrepreneurs of stage 1 or 2 in understanding the sources of Islamic finance and its implications.

Research Limitations/Implications: The paper is aimed at assisting the entrepreneurs seeking equity.

Keywords: Islamic finance; Shariah finance; Risk sharing; Islamic banks.

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INTRODUCTION

Islamic law or Shariah law could be defined as "the body of legal rules developed by Muslim scholars in interpreting the Qur'an and the Sunna, the religious texts of Islam. Islamic finance… denotes financial transactions conforming to Islamic legal principles." (Balz, 2008)

Shariah endorses freedom of contract; creativity is hence endorsed and Muslims are encouraged to invest their wealth, especially in investments that would contribute to the society as a whole. Shariah is primarily concerned with the socio-economic justice as well as the wider economic development.

The Islamic financial system promotes justice, equality, partnership and social welfare. It is an ethical system that endorses brotherhood among society members as well as creating value and maximising profits. However, the latter should be established without jeopardising the ethical and moral requirements of Shariah finance. In fact, Islamic finance sets the foundation for the establishment of a moral and a consistently growing economy that would ultimately serve the broader social welfare.

While the creation of wealth is encouraged, greed and money hoarding is not. Muslims are encouraged to invest their money and their effort to create more wealth. Consequently, keeping money idle is discouraged as well as depositing it in a bank in exchange for periodical interest payments (Venardos, 2012).

Transactions and structures that follow Shariah are subject to, inter alia, the prohibition of *riba* (the charging and receiving of interest). The charging of interest is a form of risk transfer seen in interest-based debt contracts (Iqbal and Mirakhor, 2011). In addition, Islamic finance is based on the principle of profit and risk sharing instead of risk transfer, and unlike the capitalist system, Islamic finance is equity-based rather than debt-based.

The objective of this paper is to address the concept of profit and risk sharing and its advantages to both the entrepreneur and the financing bank and to discuss how Islamic partnership contracts could offer them both more advantages than a conventional debt contract. Section 2 of this paper discusses the main underpinnings of Islamic finance while Section 3 focuses on the principle of profit and risk sharing. Sections 4 and 5 discuss two of the commonly used Islamic partnership contracts and the advantages the principle of profit and risk sharing, respectively. Finally, Section 6 is dedicated to the conclusion.

A GENERAL INTRODUCTION TO THE MAIN UNDERPINNINGS OF SHARIAH

Islamic finance is based on unique principles that widely differ from conventional finance. To start, it is an 'interest-free' system. The majority of scholars agree that interest in any form, whether excessive or not is forbidden (Hanif and Johansen, 2012). Interest is considered as an unjust enrichment of a person at the expense of another, which violates the Islamic principles of justice and social fairness (Iqbal and Mirakhor, 2011).

It should be noted that debts are not forbidden according to Islamic finance, the act of charging interest is the forbidden act due to its unlawful and exploitive character. Debts are hence repayable at par value and trading in debts is very restricted. Any addition to the principal amount, notwithstanding how it is labelled, is strictly prohibited. Whether it was labelled as interest, charge or fee, any excess is considered as *riba* (interest).

Moreover, this equity-based system promotes the concept of profit and risk sharing (this principle will be covered in more detail in Section 3). The risk transfer associated with conventional interest-based contracts is forbidden by Shariah teachings. In other words, it is considered unlawful to shift the entire risk of repayment of the principal amount and interest payments to the borrower alone while the lender retains the property right claims associated with these amounts.

In addition, property rights and contracts are sacred and should always be respected. Therefore, transactions and contractual commitments should be clear and unambiguous, clearly identifying, inter alia, the object of the contract and the rights and obligations of the parties.

Furthermore, money has a specific role in the Shariah system; it is simply a medium of exchange and a way to estimate the value of goods and services (Kettell, 2011). Kettell (2011) and Venardos (2012) further add that money itself has no value and therefore it cannot be used to make more money. Consequently, a person cannot receive money in the form of interest simply because they deposited funds in a bank account.

It is important to note that Islamic finance, while encourages creativity, it marks some industries and/or products as unlawful. This includes any assets or activities relating to pork, alcohol or pornography, etc. In addition, excessive uncertainty present in gambling and other speculative activities is also forbidden.

Finally, risk-free transactions and contracts are not authorised in Islamic finance. The element of risk in addition to labour and capital are what legitimise a transaction and render it Shariah-compliant. In other words, guaranteed transactions with profits fixed ex-ante are forbidden as they lack the essential element of risk. Islamic finance endorses participating in investments with higher risk in exchange for higher returns (Venardos, 2012). Venardos (2012) further explains that this would ultimately stimulate the economy and would incentivise entrepreneurs to give their best effort in order to maximise profits.

This Section 2 attempts to give a general introduction about a number of the main underpinnings of Islamic finance, however, in no way does it cover all of the tenets of this vast and rich field.

PROFIT AND RISK SHARING IN ISLAMIC FINANCE

Islamic finance does not endorse risk aversion; however, it does not endorse speculation and gambling either. After all, the element of risk legitimises all Islamic transactions, as transactions without risk are unaccepted according to Islamic finance. Kettell (2011) argues that the element of risk and the amount of effort a person puts to make a business succeed are ultimately more important that the capital injected.

Risk could be defined as the probability of occurrence of an event resulting in a loss (Iqbal and Mirakhor, 2011). Risk is not limited to default risk, but extends to any type of risk that would eventually cause losses (e.g. market risk, capital risk, economic risk, etc.) According to Shariah, risk thus presented should be shared by the lender and the borrower instead of being shifted to only one party.

Therefore, Islamic financial institutions are invited to create partnerships or joint ventures with entrepreneurs seeking funding instead of merely becoming creditors. The partnership agreements should clearly state the rights and obligations of the parties, roles, profit ratio as well as the extent of each party's liability. In this case, the partners will have a common objective of creating a successful enterprise that would eventually result in earning big profits for them. And unlike a conventional loan agreement, the entrepreneur does not take on the burden of repayment of the loan by himself. Also, the lending entity (i.e. bank or any other financial institution) gets the opportunity of achieving big returns that could reach multiples of the interest payments.

One should note that in a regular loan agreement, there is a clear conflict of interest present between the borrower and the lender. The borrower's main concern merely revolves around getting the necessary funding. On the other hand, the lender is concerned with receiving the principal amount lent and the interest accruing on that loan. However, in reality the borrower cannot guarantee the success of the enterprise for which he borrowed the funds. There is a lot of uncertainty on his part (especially if the borrower is starting up a new enterprise or a project) and he could eventually default on the loan. Moreover, there is often asymmetric information present in these kinds of situations which could ultimately result in asymmetric risk.

As to the bank, because it has no interest in monitoring the entrepreneur, his activities and/or the future performance of the enterprise, the borrower is prone to allocate the funds to very risky and sometimes very speculative activities and eventually risks losing the money and failing to pay back the loan.

However, when both the financial institution and the entrepreneur have the same objective (i.e. creating wealth and developing the enterprise) the level of cooperation increases and the probability of asymmetric information decreases, as will adverse selection and moral hazards.

The principle of profit and risk sharing is the foundation for all Islamic economic activities (Askari et al., 2015). Consequently, banks and financial institutions are invited to partner with entrepreneurs instead of lending them funds in exchange for fixed future payments. Thus, should a risk materialise, both parties would bear the risk in proportion to their capital contributions (Kettell, 2011). However, as to the distribution of profits, parties are free to agree on their profit percentage notwithstanding their capital contributions (Kettell, 2011). It is very important to note that in an Islamic structure profits depend on the performance of the enterprise or the business venture itself and therefore cannot be fixed ex-ante.

ISLAMIC PARTNERSHIP STRUCTURES

Subsequent to the last global financial crisis, new and more rigorous policies have been introduced to regulate, inter alia, bank liquidity and capital. Although it is not the sole contributor to the financial crisis, credit extension to borrowers that eventually became non-performing has played an important role in the manifestation of the crisis (Claessens and Kodres, 2014). After the crisis hit the economy liquidity became tight and entrepreneurs were in pursuit of scarce funding opportunities. Many Islamic banks and banks with Islamic windows offered funding that differs from conventional banks. Islamic partnership structures such as *Musharakah* (joint venture) and *Mudarabah* (passive partnership) are the most commonly offered to entrepreneurs seeking funding. These contracts emphasise the Islamic tenet of profit and risk sharing that aligns the interests of both the borrower and the lender.

In simple terms, *Musharakah* or Islamic joint venture contracts may involve more than two partners who contribute capital in cash or in kind. Partners could also contribute their knowledge, skill, advisory services and/or experience in addition to a capital contribution. When put into application, a bank and an entrepreneur become partners in the venture whereby the entrepreneur invests a part of the capital in addition to his efforts, skill and knowledge while the bank contributes capital. It is possible for the bank to have a managerial role in the enterprise in additional to any advisory services. This would depend on the parties' preference.

As to the allocation of profits, profits generated depend on the performance of the enterprise. Profits cannot be guaranteed by any party and cannot be fixed ex-ante. However, the allocation of losses is divided pro-rata in accordance to each partner's capital contribution.

When capital is pooled, the bank and the entrepreneur become partners in the enterprise and co-owners of its assets. Hence, both could benefit from the appreciation in the assets' value. (Usmani, 2002).

As to the *Mudarabah* or Islamic passive partnership contract, one partner contributes capital while the other partner contributes his work, skill and expertise. Consequently, a bank would fund the enterprise while the entrepreneur will solely manage it. In this case, the bank has no right to interfere in the management of the enterprise. However, in their agreement the partners could set limits to the entrepreneur's role. It is very important to note that the financier is the sole owner of the assets purchased in a *Mudarabah* transaction and therefore only the financier will benefit from the appreciation in their value (Usmani, 2002).

In a *Mudarabah*, the profit is shared between the partners according to their agreed ratios while the financial loss is borne by the financier who contributed all the capital. The entrepreneur's loss is limited to the loss of his time and effort invested in the enterprise.

BENEFITS TO BOTH THE FINANCIER AND THE ENTREPRENEUR

Before the last crisis hit the economy banks were prone to lend funds without meticulously examining the profitability of the ventures or projects with which they were presented, the extent of knowledge, experience and past performance of the entrepreneur. Many banks did not accurately assess the risks associated with the entrepreneur and their enterprise or venture. Instead, their main concern was the credit worthiness of the entrepreneur and their ability to pay back the loan. Hence, banks were prone to adverse selection and moral hazards.

Generally, when presented with a number of prospective borrowers, a bank has to select those who are more likely to be able to repay the loan. Banks would rely on the information provided by the borrowers to mainly evaluate the risk of default. However, because of the possible risk of asymmetric information and the inability or unwillingness of banks to engage in costly evaluation and monitoring activities regarding the entrepreneurs and their enterprises, banks require that borrowers pledge collateral to ensure that they can recoup their losses in the event the entrepreneurs fail to pay back the loan. However, the collateral cannot replace correct risk assessment, project appraisal and continuous monitoring. In many cases collaterals can become worthless, especially in the case of illiquid assets or assets affected by an intense decline in value.

In addition, the interest rate offered by banks does not normally reflect the real risk associated with each borrower and their enterprise, but instead it demonstrates the average risk rate associated with all borrowers (Gup, 2011). Therefore, borrowers with risky projects would be eager to seek funding from a bank in exchange for low interest rates that do not truly reflect the risk associated with their enterprises. Similar borrowers tend to fall into moral hazards when the funds are used in risky and speculative activities in an attempt to make higher returns (Gup, 2011). These borrowers have a higher risk of defaulting on the loan.

As demonstrated in Section 4, according to an Islamic partnership structure a bank funding an enterprise would share in the real profits and losses of the enterprise with the entrepreneur. Banks could use their funds to invest in projects or enterprises with potentially very high returns. The entrepreneur will also benefit from this structure where the risks associated with the enterprise would be distributed between them and the financier. Moreover, the enterprise will avoid big financial burdens that are normally very difficult to support, especially in the early stages of an enterprise where such financial liabilities could be very critical to the enterprise's future.

Furthermore, a conventional loan agreement stipulates that the borrower is obliged to pay the lender the principal amount in addition to the interest payments notwithstanding the performance of the enterprise. However, this kind of risk transfer does not exist in Islamic finance as the bank will only receive payment when the enterprise makes profits.

As mentioned above, Shariah encourages banks to have a more active role and are invited to become investors and/or partners with the entrepreneurs instead of mere creditors. Thus, banks would be inclined to closely examine the projects from all perspectives to ensure it grows into a successful enterprise that would eventually make big profits. Consequently, they would be more rational when assessing the risks associated with prospective borrowers.

Incentivising both the bank and the entrepreneur and aligning their interests would reduce (but may not erase) the risk of asymmetric information. Such risk is present in an Islamic context as well as in a conventional context. One party (normally the borrower) might choose not to disclose all necessary information to the other party (i.e. bank). Information concealed generally relate to the profitability or risk factors associated with the enterprise in an attempt to receive the desired loan. However, thanks to the Islamic partnership structures and the principle of profit and risk sharing, both banks and entrepreneurs have a common interest in creating value for the enterprise in order to make more profits. Banks will hence invest much more in appraising prospect borrowers, monitoring their activities and performance and might even be able to advise the entrepreneurs and assist in the management of the enterprise. As Kettell (2011) suggests, the depositor, the bank and the borrower all become partners in the enterprise.

CONCLUSION

This paper attempted to give a general and simplified demonstration of how the principle of profit and risk sharing offered by Islamic structures could benefit entrepreneurs seeking funding and financiers pursuing higher returns. Although risk of asymmetric information is always present, it could be decreased thanks to the Islamic partnership structures that align the interests of both parties in addition to incentivising them to increase cooperation and assistance and eventually decrease the probability of occurrence of moral hazards.

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BIOGRAPHICAL NOTES

Fatemah A. Al Maddah is a legal advisor at a private investment company situated in Jeddah, Saudi Arabia. She holds an LLM degree in International Business Law from the Centre of Commercial Law Studies – Queen Mary University in London and a Licence in French Law and Economic Studies from the university Paris Descartes (Paris V) in Paris. Her research interests focus on the study of Islamic finance and Islamic finance law. More specifically her work examines *Sukuk* (i.e. Islamic investment certificates) and their different structures.