Chapter 24
Risk and Islamic Finance: A Misconception Corrected

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ABSTRACT

The discussions on risk – its bearing, sharing, or transfer – have recently assumed prominence in Islamic finance literature in the wake of devastations the 2007-2008 financial crises unleashed across nations. Islamic scholars were quick to claim that there was no impact of the crisis on Islamic banks because they worked on a risk-sharing principle. In contrast, mainstream institutions suffered because they worked on a different plank – the transference of risk to other parties. This Chapter argues that neither the current practice of Islamic banking supports risk sharing as its sole principle nor do its future prospects depend on it. The proposition only seeks to put Islamic finance on a non-existent trajectory. It clarifies confusion regarding the proposition and some of its corollaries. Contextually, it deals with measurement of risk, its relationship with return to capital, and its distributional equitability. The focus of the Chapter is rather restricted. It does not deal with various types of risks the banks face in their financing activities or with issues in risk management.

INTRODUCTION

This Chapter deals with a dominant claim in Islamic banking and finance that risk sharing is the sole principle in its organization in contrast to its mainstream counterpart that relies on shifting of risks to counter parties. In this context, the research has the following as its main areas of concern.

- To explain the notion of risk and its relationship with the return to capital in productive effort in the light of literature on the subject
- To examine the efficacy of the age long ‘no risk, no gain’ adage in Islamic finance in the light of expert opinion and the maxims of the Islamic law.
- To investigate if mainstream finance subsists solely on transference of risks?

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• To examine if the mainstream banks came to grief during the 2007 financial turmoil essentially because of risk shifting.
• To investigate if Islamic banks remained unaffected during the turmoil as they operated on a risk sharing basis?
• To lay down some policy conclusions in the light of the above explorations.

**NATURE OF RISK**

Risk is a subjective entity and its objective manifestation in business is the possible emergence of loss. Individuals perceive of risk contextual to their net worth, not to what they invest. The risk feeling of losing $100 for, say A, who had only that much money would be patently far greater than of B who might lose $100 out of $10,000. A becomes a pauper while B would get away with a minor scratch. Thus, *equal* financial losses need not signify *equal* risk perceptions. And there is no way for an external observer, like an economist, to compare such perceptions, especially when net worth is just one of those numerous elements that impact that perception. Thus, the proponents of risk-sharing principle in Islamic finance can easily see the un-tenability of their position. If A and B of our example were partners in a business venture, both would share loss equally as Islam decreed, but would the risks also be shared equitably? One must not attribute to Islam what does not belong there Islam doubtless acknowledges the existence of risks in business and encourages the believers to be venturesome. It instructs them to guard against seeable risks and manage them well. But in business the instruction is to share *losses*; what risk it imposes on parties is then their personal concern, not of Islam.

Perceptions apart, there is the issue of measuring risks to see if they would be commensurate with possible losses in individual cases. This is a serious microeconomic issue. Knight (1921) and his later followers, J.F. Weston (1951) especially, are found moving unannounced between their micro and macro formulations on risk, hardly coming to grips with either.

Islamic finance is a profit and loss sharing system; not a ‘gain-risk calculus. People enter into contractual relationships for sharing business profits and losses if any; risk sharing is not even mentioned. For, risk sharing is a *consequence* of the contract, not its cause. Part of risk can be measured statistically and can be met at a cost through insurance. The other part cannot be measured *Uncertainty*, the result of immeasurability, constitutes true risk; this will be discussed in some detail later. However, risks are classified into the *exclusive* categories – insurable and non-insurable; a single risk cannot be bifurcated into such components. This abridges the scope of insurability. Furthermore, if the contractual liability of the parties were unlimited, this complexity would increase.

Before the discussion proceeds further, it would be helpful to have a brief look at the background of the origin of risk sharing versus risk transfer debate and the nature of literature on the subject.