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Article

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An analysis of the normative parameters of reward and risk in Islamic finance

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Analysis of the
normative
parameters

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Abstract

Purpose – This study aims to define the parameters of the reward-risk principle in Islamic finance as established in the literature and discuss propositions that are presented on how such a principle is to be applied to Islamic banking products.

Design/methodology/approach – A descriptive approach is used to explore the normative parameters and criticisms of the application of reward-risk in Islamic finance.

Findings – The study finds that the principle of reward-risk is embodied in the multi-component concept of *'iwad* (counter value) which must be evident in market transactions that involve commercial exchanges. The components include risk, costs, effort, value-adding and capital, all of which apply uniquely to different contractual forms of financing.

Research limitations/implications – The study uses academic literature and industry documents along with modest contact with prominent practitioners who provided general feedback on prevalent Islamic finance industry practices.

Practical implications – This study expositis the variety of approaches in applying the reward-risk principle and sheds light on the primary elements of the principle which will facilitate its greater consideration by the Islamic finance industry.

Originality/value – This study is a meaningful attempt at conveniently summing up and applying the parameters that are considered when discussing the scope of the reward-risk principle in Islamic finance.

Keywords Islamic banking products, AITAB, MMP, MPO, Reward-risk parameters

Paper type Research paper

Introduction

Islamic finance (IF) is practiced today by financial intermediaries, which circulate funds from providers to users of funds. Islamic financial institutions (IFIs) use the contracts developed in *fiqh* (Islamic jurisprudence) literature to devise products that can be used to circulate funds in a way that is Sharī'ah compliant (in abidance by Islamic law). Some

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examples of these contracts are the typical sale contract, which entails the transfer of ownership and the lease contract, which gives another party the right to benefit from the leased asset. Besides these contracts, there are principles that must be observed. They include the prohibition of *gharar* (extreme uncertainty); the prohibition of *maysir* (gambling-like speculative activities); and the prohibition of *ribā* (usury), which takes different forms such as interest on a loan. Another of these principles is matching reward with risk. In other words, the benefits that accrue to each party in a transaction must also reflect a level of risk that is assumed by that party. This principle is referred to as “reward-risk” in this study.

The words “reward” and “risk” are close interpretations of what the Prophet (peace be upon him) said and what jurists understood from *ḥadīths* (sayings of the Prophet) that pertain to such matters. These include the terms used in *ḥadīth*:

«الْخَرَجُ بِالْظَّمَانِ».

“Reward (*kharāj*) goes with liability (*ḍamān*)” (al-Tirmidhī, 1975, *ḥadīth* no. 1286).

Liability entails risk while the reward is understood to mean income. Each term, reward and risk, will be defined individually later. Until recently, IF textbooks such as that by Abojeib *et al.* (2018) have highlighted the profit-and-loss sharing (PLS) principle as the distinguishing feature between Islamic and conventional arrangements. This principle dictates that profit and capital loss in a partnership be shared among the partners. PLS is one embodiment of the reward-risk principle and is a testament to its importance, which necessitates revisiting the juristic interpretations of *ḥadīth* texts that institute this principle.

In discussing risk, conventional economists do not agree on one definition and have instead advanced various definitions of risk, some of which have more practical implications than others. According to Holton (2004), both subjective and objective theories of probabilities have been advanced in defining probability and risk. For example, Knight defines risk as an objective probability in that it is measurable yet one is ignorant of it (Holton, 2004). Keynes requires that two propositions of probability be presented to determine risk, notably an objectivist and a logical proposition, as two individuals would arrive at the same risk calculation if presented with the same propositions of probability (Holton, 2004). After analyzing several ideas on risk by prominent economists, Holton (2004) goes on to identify two important elements of risk, namely, exposure and uncertainty. IF experts have also attempted to define risk. For example, al-Suwailem (2006, p. 56) defines it as “the probability of loss.” From this definition, it is clear that risk is undesirable. Askari *et al.* (2012, p. 69) define it as the “possible occurrence of an event that leads to a loss.” They further add that such risk is reduced by transferring it or sharing it. This further distinguishes it from *gharar*, which refers to taking an excessive amount of risk (al-Suwailem, 2006; Askari *et al.*, 2012).

The concept of risk in IF will be elaborated later. Regarding the concept of *kharāj* (reward) in the previously mentioned *ḥadīth* (al-Tirmidhī, 1975, *ḥadīth* no. 1286), it refers specifically to an incident where a man purchased a hired worker (servant) but then returned him to the seller after discovering a flaw in him that had not been disclosed at the time of purchase. The owner complained to the Prophet (peace be upon him) that the buyer had used the servant’s labor during that period but had not compensated the original owner for it. The Prophet (peace be upon him) ruled that the buyer was not required to pay any compensation because he was liable for the servant during the period he had used his labor. In light of this context, *kharāj* refers to any *dakhl* (income) or *ghullah* (usufruct) and is specifically tied to the ownership from which such income is derived (al-Khatṭābī, 1932).

Some IF literature defines *kharāj* as all sorts of income that are distributed to transactors (Awidha, 2010). Some specific examples include the sale price and profit in a sale contract, the rental payment in a lease contract, the profit in partnership-based contracts such as *muḍārabah* (profit-sharing) and *mushārah* (profit-and-loss sharing) and fees in agency contracts. What constitutes *kharāj* is not a subject of unanimity and has largely been left undefined in *fiqh* and IF literature. This is, perhaps, owing to the evolving nature of Islamic financial arrangements. In an Islamic financial lease product today, for example, the Islamic bank (IB) would earn an income that is made up of the financing amount and profit, which are paid in rental installments. Attempting to fix the types of *kharāj* may work to defeat the purpose of the malleability of Shari'ah (Islamic law) and its principles of *mu'āmalāt* (transactions).

Another important introductory concept related to reward-risk is *'iwaḍ*, which is best translated as fair counter-value or compensation. Further developed by some IF experts, *'iwaḍ* traces its roots to a concept in the Hanafi School, as elaborated by the jurist al-Kasānī (1986), of legitimate return on invested equity capital. It is necessary to expound on the components of *'iwaḍ* as they represent one view of how reward-risk in IF should take form. Reward-risk parameters will be discussed and applied to the *fiqh* contracts used today for purposes of clarification. The categories of sale, lease and partnership contracts will be the primary focus. Other categories such as *qard* (loan) and *wakālah* (agency) are out of the scope of this study although they are not excluded from the implications of the reward-risk principle.

This study aims to define the parameters of the reward-risk principle in IF literature and how such a principle is to be applied to Islamic banking products. The results do not represent the researcher's opinion but are simply the product of inductive analysis. The study uses academic and industry literature with some feedback from practitioners on the actual practice for purposes of an objective demonstration of the practice. Furthermore, the study alludes to the variety of approaches in applying the reward-risk principle and sheds light on the parameters of the principle in hopes of increasing awareness of this theory, which is discussed but has not yet taken full shape. This study expects to present a unique and arguably unprecedented attempt at comprehensively summing up and applying the parameters of the reward-risk principle in their current form.

The study first conducts a review of the literature on the reward-risk principle and its application in the different *fiqh* contracts, both in their traditional *fiqh* and modern IF manifestations. Criticisms of the modern IB financing practice are also abbreviated therein. The study then presents the researcher's findings, outlining the proposed parameters of the reward-risk principle and discussing the finer elements that relate to each parameter of the principle. The last section summarizes the findings and proposes recommendations for future research.

Reward and risk parameters in the Islamic finance literature

The principle of reward-risk stems from the *ḥadīth* of *al-kharāj bi al-ḍamān* (reward is justified through liability) (al-Tirmidhī, 1975, *ḥadīth* no. 1286). This liability has been interpreted to mean liability for risk/loss or liability for sound disposition of the asset such that if the asset in a sale contract is safely disposed of by the seller to the buyer, the former deserves the income from the transaction (Mahmud, 2019). The context of the *ḥadīth* has already been discussed. Another narration conveying a similar meaning states that the Prophet (peace be upon him) prohibited that one earns a profit from something for which he bears no liability (Malik, 1985, *ḥadīth* no. 251).

IF thought has not diverged much from the established classical *fiqh* stance toward the reward-risk principle. Al-Ṣadr (1981) viewed reward being matched with risk in the likes of *muḍārabah* and *mushārah* in the form of sharing of profits and assuming risk. That is why an *ajīr* (fixed-wage hired labor) receives limited but guaranteed wages whereas a *muḍarīb* (managerial labor) is not guaranteed a return but stands to benefit a lot more from a successful venture than an *ajīr*. That is because the *muḍarīb* shares the profits of the *muḍārabah* (which refers to a venture involving two parties, a financier and a managerial laborer). Choudhury (1986) confirms that the dominant form of financing in Islamic countries was based on the principle of profit-and-risk sharing. Kahf and Khan (1992) confirm that *al-kharāj bi al-ḍamān* is an important axiom of IF. Like them, Chapra (1992) reiterates the same idea under the subtopic of equitable distribution and lists several parameters of the reward-risk principle. Equitable distribution through the reward-risk application would prevent wealth from being concentrated in the hands of a few and, in turn, achieve the ideals of the revelation (Iqbal, 1997, 1999). This is in reference to the Qur'ānic verse: "[...] so that it (wealth) may not circulate only among the rich among you" (59:7). Put simply, the reward-risk principle ensures that, regardless of the contractual methods used, commercial exchanges achieve an equitable balance of income and risk. In the context of IF today, IBs earn income from financing and they bear the risk of that financing.

The focus of Islamic economics experts when discussing reward-risk is the domain of wealth distribution and Shari'ah injunctions that pertain to it. Distribution refers to the division of products among participating factors such as land, labor and so forth (Abojeib *et al.*, 2018). The primary theme in distribution that ties it to IF is equitability. Hence, the primary concern in Islamic economics is in regulating the distribution and ensuring it is equitable, with the Qur'ān giving more attention to it than to production. This is relevant to the study at hand, as IF is a subset of the larger Islamic economic system. In an attempt to achieve the ideals of Islamic economics, IF experts and practitioners have developed contractual methods to try to achieve equity, specifically through the concept of '*iwaḍ*' proposed by some.

Rosly (2001) and Abdullah (2015, 2016) are prominent exponents of the concept of '*iwaḍ*', which for them stands at the center of the IF normative theory of profits. Hence, if income is earned by transacting parties, the requirements of '*iwaḍ*' must be properly observed for the financing to be equitable. '*iwaḍ*' is further composed of *ghurm* (risk), *ribḥ* (earnings), '*amal*' (effort) as an addition of value and *ḍamān*. In classical *fiqh* literature, '*iwaḍ*' is a prevalent theme in equity-based financing (al-Kāsānī, 1986). *Ribā* is prohibited because the lender is entitled to a guaranteed return above the principal and the guaranteed principal sum in full. This negates any risk being taken for the return earned. The mentioned components of '*iwaḍ*' have been generalized to include some sale-based arrangements. The basis for those who do this is that the Qur'ān distinguishes between an invalid *ribawī* (usurious) sale and a valid sale (Qur'ān, 2:275) chiefly on the basis of the risk involved in the latter. A slightly different set of elements comprise '*iwaḍ*' in partnerships, namely, *māl* (capital), '*amal*' and *ḍamān*, with profit-sharing being the goal of partnerships. The *rabb al-māl* (capital provider) advances capital to the *muḍarīb* (manager) who manages it. The *rabb al-māl* bears the risk of loss associated with the investment of the capital (Rosly, 2001).

The specific elements of transactional dealings to which the reward-risk principle applies (within the context of the contracts chosen in this study) include, namely, asset price for sale contracts, rental rates in lease contracts and profit rates in partnerships which are determined by the profitability of the ventures. Similarly, the risk pertains to ownership risk in sale/lease contracts and loss of capital/effort in partnership contracts.

In sale contracts, market price risk may affect profit or loss; the reward is the income from reselling the asset, but an asset may prove unsaleable due to lack of demand (Awidha, 2010). These are expressed as the benefits and risks of ownership (Kahf and Khan, 1992; Hussain *et al.*, 2016), where the possibility of profiting from a resale is met with the risk of not being able to resell the asset or reselling it at a loss or even having the asset destroyed. This distinguishes sale from *ribā* in that the latter is a risk-free “profit” (return) whereas the former is profit associated with ownership and market risk.

In leases, the rewards and risks take different forms, the most important of which are the ability to lease the assets at a good lease rate (reward) and the risk of wear and tear or of the destruction of leased assets due to *force majeure* (overwhelming circumstances) (Hussain *et al.*, 2016). The lease payments earned are due to the ownership risk borne by the lessor (Rosly, 2001). *Ijārah* (lease) is basically a sale contract, but it is done on a temporary basis and for a fraction of the price (Ibn Qudāmah, 1968; al-Ashqar, 1998; Kamali, 2007). For this reason, future lease rates should, in principle, not be fixed but rather be subjected to market conditions. However, due to the *gharar* (uncertainty) element contained in such a stipulation, Shari‘ah texts require that lease rates be defined in value (Ibn Qudāmah, 1968; Al-Zuhaily, 1984). Setting a floating lease benchmark as the basis for lease rate determination is acceptable, as the value of the index is defined at any given point in time, which eliminates *gharar* and reflects real sector lease rates (Hussain *et al.*, 2016). Alternatively, Kahf (2020a) compares the fixed-wage of an *ajir* (who leases his labor) with the varying profits of a *muḍārib* in that both do virtually the same things but differ in risk appetite. The Shari‘ah approves of both approaches of the income distribution. Reward-risk in lease contracts can take the form of the accrual of any benefits – other than those stipulated for the lessee – from the leased asset to the original owner (lessor). This is because it is a transfer of temporary right to usufruct and not the transfer of ownership; ownership remains with the lessor, which necessitates bearing the risk of loss of the leased asset (Shariff and Rahman, 2003). An implication of this, for example, is that the destruction of the asset due to the lessee’s negligence does not affect the lessor’s entitlement to rental payments (Ibn Qudāmah, 1968).

In *muḍārabah* partnerships, the profit is the return on equity while the risk relates to the capital loss of the *rabb al-māl* and the efforts of the *muḍārib*. In *mushārah*, the reward is the partners’ profit on capital and the risk is the partners’ potential loss of capital (Ibn Qudāmah, 1968; Hamoud, 1982; Khan, 1987; al-Sālūs, 1995; Ibn ‘Abd al-Barr, 2000; Rosly, 2001; Ibn Rushd, 2004; Awidha, 2010; Askari *et al.*, 2012). In parallel (two-tier) *muḍārabah*, the IB acts as a *muḍārib* initially receiving funds from depositors (as *rabb al-māl*) and then invests the capital into other projects/ventures as a new *rabb al-māl*, a novelty in contemporary IF which is alien to the classical *fiqh* literature (Kahf and Khan, 1992). It has, however, caused controversy over the method of application of reward-risk: who bears the risk of capital loss? Hamoud (1982), for example, allows guarantees by the IB because the IB itself is entitled to a profit (as *rabb al-māl* in the second tier of the *muḍārabah*) and so, must guarantee the capital. That capital, in turn, is the entitlement of the initial *rabb al-māl* (the depositors). This has been refuted by some scholars like Awidha (2010), who have discussed Hamoud’s proposition and pointed out its faults. On the same grounds, al-Ṣadr (1981) views that the initial *muḍārib* (IB) is not entitled to a share of the profits unless there is a real effort on its behalf in managing the funds of the *rabb al-māl* (depositors).

An identifiable gap in the literature exists with regard to a concise analysis and summary of the parameters of reward-risk in light of modern Islamic financial intermediation. This paper seeks to address that gap.

Methodology

This study adopts a descriptive approach to explain the concept and application of reward-risk to IB financing products. An inductive analysis of the different opinions presented by IF experts and researchers form the basis for discussing and defining the currently established normative parameters of reward-risk. Critical observations regarding prominent Malaysian IB financing products, through document analysis and practitioners' input and their reward-risk features, are also made.

Defining the parameters of reward-risk

The results reveal that market and ownership risk, transactional costs, effort or added value and risk of capital loss are all important parameters that define the reward-risk principle. Each parameter will be discussed individually.

Risk (ghurm)

Having defined risk earlier, it is necessary to systematically present it as a parameter of the reward-risk principle. In the medieval context during which *fiqh* developed, merchant-style financial dealings, rather than financial intermediation, were the norm. This meant that a trader bought goods which he sold for profit. Inherent in this process is the exposure to loss of the asset and the risk of selling it at a loss in the market. The well-established near-consensus in IF discourse is that the risk referred to here is based on the principle of *istimrāriyyat al-milk* (ownership risk) (Kahf and Khan, 1992; Awidha, 2010; Dusuki, 2016). According to earlier and later Islamic economists, owning an asset or share capital in a venture means that, to profit, one must resell it or use it to produce goods/services for sale, which naturally exposes one to market risk; this, in turn, justifies fair return: '*iwad*' (al-Šadr, 1981; Kahf, 2002; Abdullah, 2015, 2016). By inference, ownership risk and market risk are inextricable risks in the context of the reward-risk principle. The following discussion sheds light on these two forms of risk.

Market risk refers to the "change in the financial position due to changes in the value of underlying components on which that position depends" (Muhammad *et al.*, 2015, p. 308) or the "risk associated with a change in the market value of held assets" (El-Hawary *et al.*, 2007, p. 797). The free market, through its demand and supply mechanism, is the fair determinant for prices which, by logic, are important determinants of returns and profits (al-Šadr, 1981; Awidha, 2010; Abojeib *et al.*, 2018). The possession of an asset, whether physical or financial, entails that benefiting from it will require using it. This may expose it to the possibility of damage or loss, such as when the asset is leased. When individual wishes to dispose of the asset, they will likely sell it at the prevailing market price. This illustrates the risk of owning any asset and of wishing to either earn from it by using it for production or leasing it or selling it off. The questions that then arise are: how does ownership risk and market risk uniquely affect the different contractual forms? Furthermore, why are not other risks as relevant in discussing reward-risk? Finally, how do costs of ownership relate to risk?

Ownership risk and market risk are normative forms of risk pertaining to the reward-risk principle. This means that these two risks seem to embody the ideal of risk-taking to justify a return. This is clarified through a demonstration of their application to IB financing products, although the reward-risk application has theoretically been extended to a variety of other *fiqh* contracts. The primary contractual categories using IB financing products are sale, lease and partnership contracts. Reward-risk applies slightly differently to each, but the forms of risk that apply are either one or both of ownership and market risks. The third type, capital loss risk, is discussed under the section of *māl* due to its unique nature.

In *bay'* (sale) structures, market price affects the resale value of the assets (Rosly, 2001). In the case of IF today, the resale of an asset-based on a sale contract, be it *bay' bi thaman ājil* (BBA – deferred payment sale) or *murābahah* (mark-up sale) or *salam* (forward commodity sale), entails market risk (Khan, 1994). The BBA and *murābahah* contracts are mark-up modes which were, and still are, used excessively in Islamic banking and finance (Khan, 1994; Suzuki and Miah, 2018) and entail the sale of an asset already in the possession of the seller. Hence, the sale price, whatever it is, can only be determined after the buyer agrees to buy the asset, in turn, exposing the seller to market risk (Rosly, 2001). Alternately, the seller may not find a buyer for a period in which market values of the asset change and when a buyer comes along, the agreed purchase price may be different from the cost of the asset (either less or more, entailing a loss or profit). The analogy drawn here is that the IB is the seller and the customer is the buyer. The market risk here should be duly borne by the IB.

Financial engineering has allowed for the development of the likes of the *murābahah* to the purchase orderer (MPO) which essentially eliminates any market risk in that the IB will only purchase the asset to resell it at a higher value if the buyer undertakes, in a binding manner (legally enforceable), to purchase the asset from the IB (Awidha, 2010). *Murābahah* initially did not entail risk-free profit in *fiqh* discourse (Abdullah, 2016). Similarly, *inah* (deferred payment sale followed by a spot payment repurchase of the same asset) mitigates market risks (Abdullah, 2015). By inference, *tawarruq* (like *inah* but includes a third party) does so and the two sale transactions are affected simultaneously which leaves no room for exposure to market forces (Khan, 2009; Dusuki, 2010). While such financially-engineered arrangements do mitigate market risk, they do not necessarily do so in regard to ownership risk, as the financier bears the ownership risk in mark-up modes, up and until the asset is sold to the customer (Hamoud, 1982; Khan, 1994; Kahf, 2006). Ownership risk will be discussed shortly. Figure 1 illustrates the structures of an MPO, *al-ijarah thumma al-bay'* (AITAB) and *musharakah mutanaqisah* partnership (MMP).

In lease-based arrangements, such as property, equipment and vehicle finance, the value of the lease is determined by the cumulative rental rate (sum of all rental payments). Hence, a lease asset's usefulness to the lessor is subject to the prevailing lease prices in the market. Alternately, prospective lessees vie in bargaining for below-market rental rates subjecting the lessor to market price risk, and all the while the lessor is exposed to ownership risk. In more complex lease-based arrangements such as the Islamic financial lease like AITAB (an Islamic financial lease used in Malaysia as detailed in Figure 1), market risk is technically irrelevant. The claim is that the lessor (IB) should normally be exposed to prevailing market rental rates. The claim further purports that the IB's return on the leased asset should be – all else equal – positively influenced by higher rental rates. Instead, the IB would not necessarily fix the rates but guarantee itself a certain income so as to recuperate the purchase costs of the leased asset plus the desired profit throughout the lease; or through the lease and subsequent sale of the asset. The issue of variable rental rates being subject to market rates is arguable, but what is not arguable is the fact that market risk becomes almost irrelevant in an AITAB. Thus, it is observed that the mitigation of market risk, which is achieved through the guise of credit guarantee (through a *wa'd* or undertaking that requires all rental payments be made by the lessee) and long lock-in periods, is what renders the Islamic financial lease incoherent with the reward-risk principle. Figure 1 also illustrates the reward-risk elements of an AITAB.

Partnership-based arrangements, mainly *muḍārabah* and *musharakah*, entail the sharing of profits and losses. The IB advances capital to the customer, be it to finance an asset or a venture. Jurists have established that the profits are the returns on capital invested while the losses include losses on capital invested, and of effort and managerial labor by the

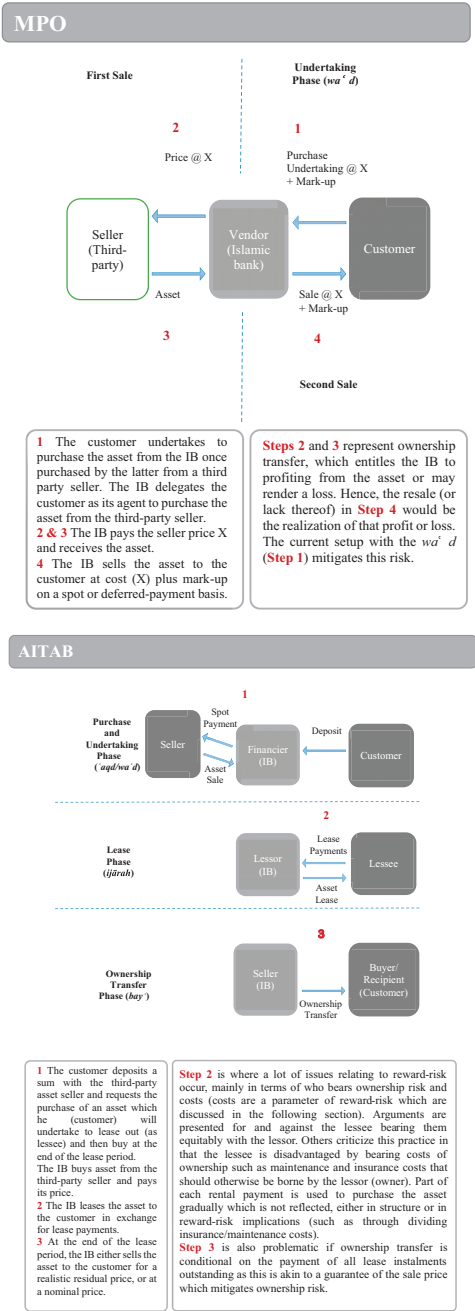
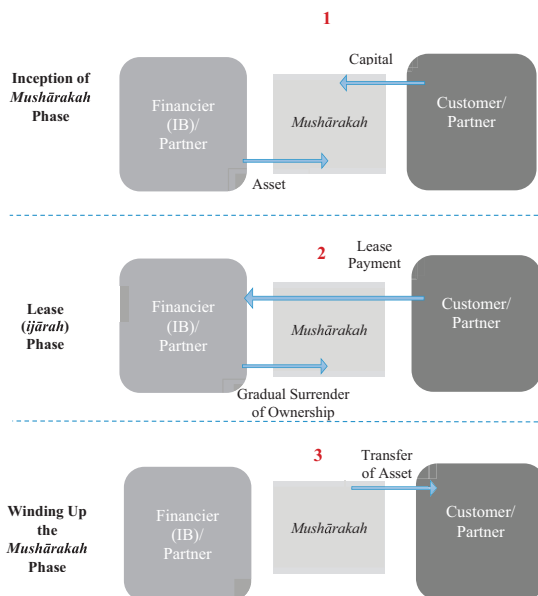


Figure 1.
Reward-risk
illustrations of MPO,
AITAB and MMP

(continued)



- 1** The customer and the IB enter into a *musharakah* agreement in which the first contributes a down payment to the asset seller and the IB buys the asset by contributing the rest of the cost (subject of financing). An undertaking is also made by the customer to lease the asset from the IB for use by the customer.
- 2** Lease payments are made periodically to the IB for the usufruct of the asset and the purchase of the IB's share by the customer.
- 3** The *musharakah* ends (is wound up) when the customer has completely paid for the asset's value (or financing plus profit), in which case full ownership would be the customer's.

Sharikah al-' aqd (partnership) model

Step 2 represents the *musharakah* returns whose profits are distributed based on a profit-sharing ratio (PSR); defaults in **Step 2** mean that the IB and the customer as partners bear the losses equally after the asset is sold in auction. Costs including tax, insurance and maintenance are borne equitably. **Step 3**, in substance, represents an ownership transfer which would have been preceded by the risk of loss due to changing market prices. The practice does not reflect this as costs are fully recuperated by the IB through the binding undertaking by the customer to purchase all of the IB's shares in the asset and indemnify the IB against any shortfalls in recovering its capital and costs in cases of default and foreclosure.

Sharikah al-milk (co-ownership) model

Sharikah al-milk does not specifically concern a PSR or PLS meaning that in **Step 2**, the IB may acquire all of the returns relating to the asset if it and the customer mutually agree to do so – while gradually selling its share to the customer at the same time. In **Step 3**, the IB may require the customer to purchase all of the shares or foreclose the asset in case of default to recover the value of its financing and related costs since no explicit prohibition of *sharikah al-milk* exists to prevent this.

Source: Author's own

Figure 1.

partners. In *muḍārabah*, capital is given by the IB (*rabb al-māl*) to the customer (*muḍārib*) as venture finance. In *mushārahah*, the IB and customer share in the venture by both contributing capital into it or in owning an asset. In both cases, the basic rule is that the IB and customer share the profits. If a capital loss results, it is borne solely by the IB in the *muḍārabah*, whereas it is shared between the IB and customer in the *mushārahah*. As partnership contracts pertain to the parameter of *māl* (capital), their unique nature will be further elaborated when discussing the *māl* parameter.

Al-Sadr (1981) stipulated that a *muḍārib* (A) cannot invest the capital vested to it by the *rabb al-māl* with another *muḍārib* (B) by an arrangement in which no effort or labor is exerted. This is because the first *muḍārib* (A) would earn a profit that is not matched with the risk of loss of effort as no effort was put forth, to begin with. What is relevant here is that the risk of loss of capital entitles the *rabb al-māl* to a return while the risk of wasted efforts or labor is what entitles the *muḍārib* to a share in the profits. A *wakīl* (agent) may be delegated instead of a *muḍārib*, in which case the former receives an *ujrah* (fee) for its efforts while the *muwakkil* (principal) still bears the full risk of losing its capital and is entitled to whatever remains after the agent receives its fees. This is a form of investment called *wakālah* finance, which is not practiced as a direct financing product but merely used as a supplementary contract in IB financing facilities.

More complex partnership structures include the MMP offered by IBs for asset financing. Market risk is not so relevant in the MMP structure, as one of the partners – the one providing the majority of the financing – ensures that it will recuperate the full costs of the financed asset along with desired profits from the initial down payment and fixed or floating rental rates. This is done through the guise of credit guarantee mechanisms such as *waʿd*, which requires the purchase of all of the IB's shares in the asset by the customer. This renders market risk completely irrelevant as the value of the financing for the financier does not change with changing asset values or market rental rates. This is why a Sharī'ah committee member of a Malaysian-owned IB cited by Zabri and Mohammed (2018) views MMP in practice as more of a sale-based arrangement with fixed returns. The same individual states that the MMP may also have an economic output similar to that of an AITAB, raising questions as to the embodiment of PLS in MMP products. Figure 1 further illustrates this.

Ownership risk should apply differently to the different contractual categories discussed, as they are fundamentally different. Sale contracts entail the sale of an asset already in the possession of the seller while lease contracts entail the rental of an asset that may or may not be in the possession of the lessor. Partnerships may have capital in the form of money, in which case ownership risk is not directly relevant. It is then observed that ownership risk is what eventually exposes the asset owner to market risk. Without ownership risk, the asset owner cannot bear market risk, as, according to the Prophetic narration, one is not allowed to sell that which he does not own (al-Tirmidhī, 1975, *ḥadīth* no. 1232). This is relevant, as more complex forms of the aforementioned arrangements like the MPO claim to feature ownership risk but mitigate all market risk, which raises doubts about the structuring of such forms of financing and their consideration for reward-risk. The reader shall be reminded here that to make sure that the proceeds of the financing are distributed equitably, risk must match reward. It has also been shown that the AITAB and MMP products do not regard market risk at all, meaning that the lessor and the partner have ownership yet are exposed to no market risk.

In conclusion, *ghurm* is risk and can take various forms, from market or ownership risk to loss of expended effort. Modern IB financing products have not properly observed these risks. The reason must be either that the proposed parameters of reward-risk are unrealistic

or rigid or that the practice has intentionally ignored their consideration. However, there are other risks that are inherent to exchange or market transactions but which are not considered to fall within the scope of the reward-risk principle, as will follow.

Other risks

The main premise for the lack of extensive concern with other risks when dealing with the reward-risk parameters is that such risks may be permissibly or forcefully mitigated (as part and parcel of achieving justice), such as credit risk and certain fiduciary risk, respectively. Alternately, these other risks may be inherent in the transaction and so cannot possibly be eliminated fully, such as business risk. Or it may be that such risks do not directly affect the reward-risk principle:

- *Credit risk*: It is well-established in the *fiqh* literature that credit risk can be mitigated through *kafālah* (guarantees) or *rahn* (collateral), be it credit arising out of a sale, lease or some other contractual forms (Al-Zuhaily, 1984). Other similar risks faced by IFIs in financing activities include counterparty and default risks, which have similar implications.
- *Business risk*: It is inherent and internal to every business, including IF business and cannot possibly be averted fully, but it is rather managed. However, one of the most important components of business risk is market and ownership risk, meaning that business risk is a result of the aggregation of such risks – a broader category that concerns institutions rather than individual transactors as was the context in which *fiqh* developed (Awidha, 2010; Dusuki, 2016). Muhammad *et al.* (2015) affirm that such risks in IF are shared by financiers and financing recipients (customers) as in the case of *muḍārabah* and *mushārah* financing, at least theoretically. In the case of *ribā*-based financing, such risks are generally borne by (transferred to) the borrowing customers and not the lenders (Dusuki, 2016).
- *Fiduciary risk*: In the form of negligence or breach of terms, it is mitigable by the nature of Shari'ah contracts through the imposition of *ḍamanāt* (indemnities) and *ta'wīḍāt* (compensations). The fiduciary risk may take the form of market risk when investment account holders (IAH) do not receive the expected market return, as investment accounts are a *muḍārabah*-type investment by the customer (*rabb al-māl*) in which the IB is the *muḍārib* managing the funds (Dusuki, 2016). It may, in this regard, be mitigated when a loss is due to negligence (*ihmāl*) by the *muḍārib*. Other risks interact with fiduciary risk; for example, Shari'ah non-compliance risk, as it is related to complying with Islamic requirements for IFIs to conduct their business in the best interest of their stakeholders through the facilities of a Shari'ah advisory board (Archer and Karim, 2007).
- *Other risks*: Shari'ah non-compliance risk does not have a direct bearing on the reward-risk equation as it pertains to distribution. Mark-up and price risks share features of market risk (Archer and Karim, 2007). Equity investment risk is a product of a series of the aforementioned risks, especially market risk, as the equity investments of banks on their trade books, for example, depending on market prices. Equity investment risk is also present in investment banking and private equity businesses of IBs which means that their value is influenced by market factors, among other things (Dusuki, 2016). Operational risk, according to Dusuki (2016), maybe accepted or avoided. In other words, it may be managed by the skill of the *muḍārib*. Various other risks exist; the foregoing discussion is for illustrative purposes and is not an exhaustive discussion of risk.

To sum up the parameter of risk, the current claim is that achieving justice in financial dealings involving Islamic contracts of market exchange is done through equitably apportioning reward and risk. The focus is set on market and ownership risk where other risks may or may not be directly relevant. Capital loss risk is related to the *māl* parameter, which shall be discussed shortly.

Damān and risk

Damān is an Arabic word that refers to liability or guarantee ([Abū Ḥārith, 2003](#)). It appears in the *ḥadīth* and the maxim derived from it: *al-kharāj bi al-ḍamān*. In another tradition, *yudman*, another derivative of the same root, is used: *ribḥu mā lā yudman* (the profit of that for which no liability is assumed). In either case, [al-Zarqā \(1989\)](#) ties it to the liability of loss which entitles the owner to *kharāj*, which he defines as any product of the asset that is separate from the asset.

For the purpose of this study, the latter meaning is the one intended; that is, the possibility of having to guarantee the loss or damage of capital, be it physical or financial. If it is owned by the party responsible for *ḍamān*, then such a party is required to bear the risk of losing its capital. Put differently, as the jurist [Abū al-Faḍl \(1937\)](#) argues, *ḍamān* follows (is bound to) ownership. In fact, jurists in general establish that *ḍamān* in this case refers to bearing the risk of loss of capital, be it physical or financial ([Al-Zuhaily, 1984](#); [Abū Ḥārith, 2003](#)). [Al-Ṣadr \(1981\)](#) uses the terms *ḍamān* and *mukhāṭarah* (risk) interchangeably but emphasizes that the focus is on the ownership itself that entitles the owner to an income and not the risk. What has been discussed under the topic of risk is then a discussion of *ḍamān* itself, and it does not appear that *ḍamān* requires further elaboration.

Costs and reward-risk

In financing assets, whether through the participatory (equity) approach or through the pure financial intermediation approach, costs related to an asset or venture financing are an important consideration as overburdening one party with certain costs could throw the reward-risk equation off balance. In the case of production, [Shahātah \(2020\)](#) makes the argument that anything unrelated to the production of the asset, such as the personal expenses of the producer, is not included in its costs. This is only fair as a potential buyer pays for the asset and its related costs, and is not responsible for the finances of the producer. The discussion of acquiring or producing an asset and its related acquisition costs is relevant to costs in financing assets, as the financing transaction should be independent of the financing entity. The personal finances of the financier should not influence the financing transaction between the financier and the recipient of financing ([Shahātah, 2020](#)). This has real implications on distributing costs, risks and rewards that relate to IB financing activities.

Jurists have elaborated on the topic of contractual expenses and who should bear which expenses. Examples of that are cited in [Al-Zuhaily \(2006\)](#), but not in the context of financing by financial intermediaries, as the latter is alien to the juristic literature ([Kahf, 2006](#)). [Chapra \(1985\)](#) claims that financiers may charge only out-of-pocket expenses to their customers unless PLS modes are used, as PLS modes require that expenses be subtracted from the capital of the *mushārakah*. That is not the case, however, with non-financing activities where the IB may charge customers both out-of-pocket expenses and opportunity costs – such as in remittance services. The rationale behind this is that in the former case, the IB and customer stand to profit and should, thus, bear the costs equitably. In the latter case, it is the customers only that benefit from these services and should, thus, bear the expenses related to them. Put another way, realistically, the IB must ultimately earn a return in excess of the

expenses from offering such services or else it would not offer them. According to Chapra's opinion, out-of-pocket expenses may include costs of acquiring assets, as in MPO or insuring and maintaining the asset, as in AITAB. In the scope of sale and lease financing methods, ownership is relevant as is evident from the literature review. Expenses related to ownership are borne by the owner, such as insurance for delivery of the asset from the third party to the IB in an MPO and such as insurance costs of the asset being leased in an AITAB. This is because, in both cases, the asset is considered to be under the ownership of the financier (Chapra, 1985; IIFA, 2000; Kamali, 2007; Awidha, 2010; BNM, 2010; AAOIFI, 2017).

In partnership modes of financing, the mutual nature of the contract entails the sharing of costs, as they are the main impediment to realizing profits. This is done by subtracting them from total returns to arrive at the profit that will be distributed to the partners and managers. In ascertaining which costs relate to the income and which do not, al-Shā'ir (2010) establishes that jurists left their determination to the custom of traders at the time. Ascertaining such expenses was relatively easy and small in scope in earlier times, but today's setting in IB has changed drastically. As a practitioner and a member of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), al-Shā'ir (2010) affirms that different IFIs have factored in different expenses in calculating net profits to be distributed to IAHs. He gives examples of the kinds of expenses that are subtracted from total income and those that are subtracted specifically from the IAHs' share of profits. Although it is not the purpose of this section to criticize industry practice, al-Shā'ir does convey his concern regarding the fairness of the practice and its integrity. Other criticisms of cost distribution in partnership-based IB financing are that the financier in an MMP may impose on the customer taxes and other expenses that should ideally be shared between them (Meera and Razak, 2005). However, the difference between the MMP and *muḍārabah*-based investment accounts is that the asset being financed in the MMP is co-owned by the IB and the customer, and hence causes greater problems in apportioning responsibility for expenses (Meera and Razak, 2005, 2009; Azma *et al.*, 2014; Zabri and Mohammed, 2018).

Still, other views exist to challenge these, such as the fact that jurists have more often than not resorted to *ʿurf* (industry convention) in determining the fair distribution of costs. They argue that the same would apply in the determination of asset cost in MPO (Eid, 2011) and who bears maintenance and insurance costs in AITAB. Kahf (2020b) affirms that they are ownership-related expenses, but they may be charged to the customer. Besides major ownership-related expenses such as insurance, no definitive principle or consensus opinion exists for the division of costs. In principle, costs reduce total income from a transaction and so directly affect *kharāj*. Equitability in apportioning them seems to be best determined by inferring from the previously cited sources, namely, by what industry convention deems fit, as long as fairness is upheld.

Work, effort and adding value

The next parameter of reward-risk is adding value, which refers to the economic value added through IF transactions. IB financing transactions involve property in the form of physical capital (assets) or monetary capital (equity). If relevant risks are present in the financing transaction, it is considered value-adding. It is claimed that this is because bearing risk is the way to add value to the economy. Relevant risks include ownership risk, market risk and capital loss risk (which shall be discussed later under the parameter of *māl*). The following is a presentation of relevant scholarly opinions on the parameter of effort and added value.

In the *fiqh* tradition, '*amal* (labor/work) that entails exertion is an established economic factor that entitles the *āmil* (laborer/worker) to fair compensation (al-Kasānī, 1986). Al-Ṣadr (1981) opined that a *muḍārib* may not advance the capital given to him by the *rabb al-māl* to another *muḍārib* on the basis that the latter *muḍārib* earns a percentage less than that which the former *muḍārib* earns. Put simply, entrepreneur A advances venture capital to entrepreneur B and earns a profit from it that is not justified as A did not exert any effort to realize added value. Al-Ṣadr likened this to A (e.g. the IB) taking the difference of profits received from B (recipient of financing) and those distributed to the initial *rabb al-māl* (IAHs) without the real effort involved on the part of A. This is clear evidence that the earliest contemporary Islamic economics did indeed observe '*amal* as a fair requirement for compensating labor factors of production (which some require that IFIs replicate). In the case of '*amal* done by the *ajir* (hired labor), it is to be fairly compensated if it is completed, even if there is a disagreement between the contracting parties or a nullification of the labor contract. Payment shall be according to the prevalent rates, although there are some disagreements among jurists on the detailed rulings (Al-Zuhaily, 1984; al-Quradaghi, 1988). The preceding opinions are generalized to include the effort of all sorts and not just *muḍārabah* and labor contracts. Abdullah (2015) views that '*amal*, which is synonymous with *kasb* (earning), entitles one to counter-value. This is synonymous, according to some literature, with the addition of value (Rosly, 2001; Rosly and Sanusi, 2001). This concept of adding value, which ties transactions to the real economy, is prevalent in IF literature and further associated with reward-risk (Rosly, 2001; Rosly and Sanusi, 2001; Kahf, 2006; Asutay, 2008). These opinions converge on the importance of effort in IF transactions.

Two important points can be inferred from this brief discussion regarding this parameter of reward-risk. First, work or effort is a factor, which should be rewarded with wages or some other form of compensation, and secondly, it should be done fairly so as to realize fairness and justice. Al-Quradaghi (1988) establishes that the objective of '*iwad al-mithl* (standard compensation) is the realization of justice. This is extended to include the compensation of work and effort through *ajir al-mithl* (standard wage/fee). An analogy is drawn between this and other cases such as *muḍārabah* where the *muḍārib* is compensated according to the profit share for his efforts and risk-taking. This is extended to other forms of risk-taking including ownership and the taking of market risk. This is evident in IB financing products, which do not directly involve physical effort but involve effort in risky forms of financing services rendered by the IFI such as sale- and lease-based financing. The issue lies with the substance of these products and whether they ultimately expose the IB to ownership and market risks. This contrasts with conventional economists' opinions on added value. For example, a number of conventional economics researchers hold that the very activity of intermediation and bringing sellers, buyers and financiers together is the essence of the value added by banks and other financial intermediaries (Wang, 2011; Alon *et al.*, 2011).

There still does not seem to be a single unified definition of added value among IF researchers. Hence, the following is an attempt to connect the dots from the preceding discussion:

- Rosly (2001) links added value to the effort.
- Kahf (2006) views added value in contrast with pure wealth transfer (such as through *ribā*-based finance). Other prominent IF experts such as Khan (1994) also emphasize this point.
- The common denominator of Rosly (2001) and Kahf's (2006) propositions seems to be the presence of effort and risk.

- [Suharto \(2014\)](#) cites effort as a factor in trade (*bay'*) in which risk, and not just time value, entitles the seller to a profit on the sale. If the risk is present, the seller is entitled to a mark-up profit because he sold the asset on a deferred payment basis (extending credit to the buyer).
- Furthermore, there is an emphasis on risk-taking ventures such as *muḍārabah* and their link to added value by both prominent and lesser-known IF researchers ([Rosly, 2001](#); [Rosly and Sanusi, 2001](#); [Kahf, 2002](#); [Asutay, 2008](#); [Gulzar and Masih, 2015](#); [Hussain et al., 2016](#)).

Relating this discussion back to the parameter that is to be established for reward-risk, it can be noted that:

- '*Amal* is directly related to adding value.
- Adding value through risk-taking entitles the risk-taking party to fair earnings or reward. In a sale or lease, this takes the form of ownership and market risks. In *muḍārabah* and *mushāarakah*, it takes the form of loss of effort and capital loss risk. This can be extended to any other exchange-type *fiqh* contract.
- Risk is inherent in any commercial activity that adds value, thus entitling the bearer of risk to income.
- An example of this is embodied in the essential Sharī'ah prohibition of *ribā*, in that the lender does not risk its capital and effortlessly ensures a profitable return adding no value as a financier in the transaction. This is contrasted with the other forms of contracts such as sale, lease and *muḍārabah*, which involve a degree of risk.

Māl (capital)

In IF, the idea of capital is derived from the Islamic economics understanding of *māl*. Capital can take physical or monetary form. It can also take the form of credit such as in *salām* (forward) and *istiṣnā'* (construction) sales or equity, such as in *muḍārabah*. Various *fiqh* works and compendiums like those developed by the Ministry of Awqaf and Islamic Affairs (1983) and [Al-Zuhaily \(1984\)](#) cite the juristic rule that the entitlement to profit by the profiting party requires the party to either expend effort, assume *ḍamān* or commit *māl*. This is traced back to a Ḥanafī principle articulated by [al-Kāsānī \(1986\)](#) and others. It is important to note, however, that when capital is considered a factor which entitles its owner to a return, it is not because of the money itself, but rather the money which, through turnover, is turned into goods and services. The goods and services are further sold for a counter-value which may result in a profit (capital gain) or loss (capital loss). Put more simply, the owner of capital is the owner of the goods and services being bought and sold using that capital (al-Ṣadr, 1981; [Kahf, 2002](#)). It is understood from this point that the risk of using capital affects the owners of capital directly. This is what is referred to as capital loss risk. IBs, as the owners of capital, are subject to this risk to justify their income if equity-based methods that use capital are used for financing.

This contrasts with *ribā*-based lending, which is capital in the form of monetary credit advanced to another party. The capital is still owned by the lender and is guaranteed by the borrower, along with the mandatory interest payments. This implies that the risk of lending does not affect the lender directly, but rather impacts the borrower who is obliged to repay the debt regardless of his business's outcome. Lending at interest affects the lender indirectly through credit risk and opportunity cost that is lost in case the lender fails to

recuperate the value of his loan. IF takes *ribā*-based lending and transforms it into equity-based financing – at least in theory, as it is not necessarily used in practice. Other forms of financing such as sale- and lease-based financing also fulfill the objective of justice and provide an alternate to *ribā*-based lending through observing the appropriate ownership risk and cost requirements discussed earlier.

In defining this parameter of reward-risk, an IFI provides financing to earn a return that will differ in nature based on the type of contract being used. Risk must be borne by the financier, be it in the form of ownership risk of physical assets or equity risk in the form of *māl* invested into the venture of a customer (Kahf, 2002). This is not to say that risk is sought after in IF (Kahf, 2006; al-Suwailem, 2006), but rather it is a way to compensate the owner of the capital. Otherwise, the other party would have to bear the risk while paying a price for financing, which is a form of *ribā*. Risk is then evidence of ownership of *māl*, which is a means of earning a profit on such *māl*. In MMP, the case is a bit different, as the asset of the *mushārakah* is considered to share capital and in the case of a liquidation event, the asset is turned into monetary capital to be distributed among the partners, the IB and the customer. In this case, the rule is that the IB equitably shares the risk involved in the possible loss of capital with the customer, based on the share of each party. This is one proposition, with the other being that MMP is *shirkat al-milk* (co-ownership), whose parameters are not strictly defined by scholars.

Another important distinction is that profit on *māl* is justified if capital loss risk genuinely exists. Profit on a loan is *ribā*, as there is no capital loss risk on a loan – it is guaranteed. In both cases, capital is advanced as a form of financing, but the distinguishing factor is the risk, which renders the profit legitimate or not. This is difficult to demonstrate in IB financing today as IBs simply do not use equity capital for financing due to the high equity and capital loss risks involved.

Table 1 summarizes the preceding discussion and demonstrates an example of each parameter of reward and risk.

Conclusion and recommendations

In summary, reward-risk in IF is undoubtedly an important concept that has garnered much concern and criticism. It is claimed that the proposed parameters of reward-risk will achieve justice. They include consideration of market, ownership and capital loss risks, contractual costs and effort that adds value. There are alternate propositions that do not strictly uphold these parameters but also achieve justice.

The study discovers that *ghurm*, being the first parameter of reward-risk, can take various forms, from market or ownership risk to loss of expended effort. However, there are other risks that are inherent to exchange or market transactions that directly affect IFIs, and IB financing facilities in particular, but which are not considered to fall within the scope of the reward-risk principle.

Damān is directly linked to risk, as it refers to bearing the risk of loss of capital, be it physical or financial and, as the terms *damān* and *mukhāṭarah* (risk) have been used interchangeably by scholars. Costs reduce the income of the relevant party in a transaction and so directly affect *kharāj* (reward). Some have argued that apportioning costs must observe a fixed set of rules, but others argue that it may be dictated by industry convention as long as fairness is upheld. The concept of adding value means adding value to the economy, which is achieved by expending effort through some sort of risk-taking. This is a distinguishing feature of IF that differentiates it from the risk-free or effortless nature of interest-based lending in conventional finance. Ownership of *māl* is also a parameter which

Element	Remark	Example
<i>ʿIwāḍ</i>	This is the concept of fair counter-value which pervades Islamic exchange dealings of economic agents including financiers and recipient of financings	An asset sold is exchanged for the price paid. An asset's usufruct is granted temporarily for rental payments paid
Risk	It refers mainly to the risk of an uncertain outcome related to asset ownership or the buying and selling of assets in the market. It concerns ownership, market and capital loss risk. Risk varies: some forms may be mitigated, other forms may not; yet others are unavoidable and may only be managed	Ownership risk occurs when possessing inventory that cannot be sold or is sold at a loss or which may be subject to loss including damage or destruction. IBs subject themselves to ownership risk in selling assets such as property and vehicles and – theoretically – in financing venture enterprises which impact on their returns
<i>Ḍamān</i>	The liability of bearing the aforementioned risks rests upon the transacting agents equitably according to the contractual forms undertaken	The asset vendor in an MPO/AITAB financing will bear the liability of destruction of the asset as it is the actual owner. In MMP financing, the bank and customer as partners will equitably bear the loss of contributed assets/capital in the case of destruction of the asset being financed
Value-adding	Effort leads to adding value and is indicative of real economy contact and inherently entails the bearing of risks (ownership, market and capital loss)	In a <i>ribā</i> -based loan, no value is added as a loan is made, pursuant to which the principal and an increment are returned with no risk to the lender. In a valid (permissible) sale, the asset is sold at a mark-up price facilitating a trade transaction between producers and consumers; the vendor would bear the risk. A partnership-based financing mode also adds value through the facilitation of trade or business. Risk is evident in either form of financing
<i>Māl</i>	<i>Māl</i> , as a factor of production, is subject to risk as other assets are. <i>Māl</i> is used to finance assets, projects and ventures which represent activities that bear capital loss risks to the owners of capital (partners/ <i>muḍārib</i>)	In an MMP, the IB uses its funds to purchase an asset, which is then contributed to the <i>mushārahah</i> , with the customer contributing a percentage of his/her own monetary capital. Both are forms of capital that are staked in a <i>mushārahah</i>

Source: Author's own

Analysis of the
normative
parameters

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Table 1.
Proposed theoretical
parameters of the
reward-risk principle

is evidenced by the presence of capital loss risk in equity-based financing transactions; otherwise, they would not be different from a risk-free *ribā* loan.

Each of the parameters contains a set of conditions to be considered when using IF to ensure the financing transaction is fair and just. As is evident from the research, industry practice has consistently avoided the proper observance of these parameters while advocates of the proper application of reward-risk have been ardent in reinstating the importance of them and the necessity of adhering to their specific forms. This raises the question of whether it is allowed for such parameters to be adapted to the innovative and

flexible nature of IF transactions, especially in financing activities, as advanced by some of the competing opinions that have been presented in this study.

In that light, it is recommended that the following areas and propositions be looked into further and given serious consideration in future research:

- A novel model of Islamic financial intermediation based on a positive analysis of the greater global financial landscape is required. This may help define an alternate pragmatic set of parameters for reward-risk.
- There needs to be a greater presence of *maqāṣid*-based reasoning which refers to scholarly conclusions and judgments based on the objectives of the Sharī'ah and which allows for multi-dimensional reward-risk considerations for Islamic financing products.
- Relevant to the previous point, a more sophisticated framework of reward-risk needs to be laid down which is well-grounded in normative principles but adaptive to reality.
- Critical approaches to the existing classical *fiqh* and contemporary literature are required to maintain the relevance of the Sharī'ah to the ever-evolving nature of finance and other aspects of life.
- A critical approach to the nominate contractual forms is called for to determine their malleability – which principles stand and which do not – in developing hybrid and composite Sharī'ah contracts essential for today's complicated and diverse financial and capital mobility needs.

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Further reading

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