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بعنوان:

Risk Sharing in *Mushārah* Contract: Theory and Practice

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Abstract

The risk sharing concept has recently gained its popularity among the scholars, economists and practitioners despite the fact that Sharī'ah has long endorsed it as an ideal mechanism for all economic activities. Risk sharing, as an alternative to the prevailing interest-based system, promotes the sharing of resources between the rich and the needy, thus leads to establishing socio-economic justice in the society. Nonetheless, not many studies have established a well-defined concept of risk sharing from the Islamic law perspective, particularly in the context of *mushārahakah* and examined its application in the modern Islamic finance. The main objective of this paper is to formulate a general theoretical understanding on the risk sharing features that are inherent in the *mushārahakah* contract by examining the subject of risk sharing in the contract and investigating the prohibitive elements that may arise from the violation of the fundamental risk associated with *mushārahakah* contract. The paper also explores whether the contemporary application of *mushārahakah* contract in Islamic finance truly adheres to the ideals of risk sharing by delineating several examples of products that utilize *mushārahakah* as its underlying contract. To achieve its objectives, the study relies on the content analysis of the classical and contemporary literature. The study finds that some contemporary Islamic financial products that are structured based on *mushārahakah* are not in line with the true spirit of risk sharing. Therefore, it is recommended that Islamic finance should adhere to the risk sharing features of *mushārahakah* contract for such adherence will promote justice and fairness to all contracting parties.

Keywords: Risk sharing, *mushārahakah*, interest-based, Islamic law, contract

1. Introduction

After the recent 2007-2008 global financial crisis which adversely affected the United States of America, United Kingdom and European countries, many have advocated to the risk sharing concept as an inherent feature that distinguishes Islamic finance from the interest-bearing system. For instance, Iqbal and Mirakhor (2011) stressed that risk sharing has long been endorsed by Sharī'ah as the ideal organizational structure for all economic activities. Through risk sharing individuals can mitigate various types of risks such as injury, illness, accident and bankruptcy that they encounter in different circumstances of their lives. In addition, risk sharing helps to promote the sharing of

resources between the rich and the needy, thus leads to establishing socio-economic justice in the society.

The concept of risk sharing is always associated with equity-based contracts such as *mushārah* and *muḍārah* which represent an alternative to the debt-based instruments. This study therefore aims to highlight the risk sharing features that are inherent in the *mushārah* contract. In particular, the paper focuses on the features of risk sharing in contractual partnership (*sharīkah al-‘aqd*) as it is more of investment in nature, where profit and loss are its essence. Accordingly, the paper examines the subjects of risk in *mushārah* contract and the prohibitive elements that arise from the violation of the fundamental risk associated with *mushārah* contract. This examination is an endeavor to provide the theoretical framework on risk sharing in the *mushārah* contract. Thereafter, the paper investigates whether the contemporary application of *mushārah* contract in Islamic finance truly adheres to the ideals of risk sharing by delineating several examples of products that utilize *mushārah* as its underlying contract.

The proceeding sections of this paper are organized as follows: Section 2 explains the notion of risk sharing in Islamic finance; Section 3 discusses the meaning of *mushārah* contract and its main categories; Section 4 sheds light the features of risk sharing in *mushārah* contract; Section 5 delineates some contemporary applications of *mushārah* contract in Islamic finance industry as an attempt to examine whether the concept of risk sharing has been exemplified in its implementation; and Section 6 finally concludes the findings of this paper.

2. What is risk sharing?

Scholars, economists and practitioners have different opinions regarding the conceptual framework of risk sharing. While some hold the view that risk sharing is limited to partnership-based contracts such as *mushārah* and *muḍārah* only, some argue that risk sharing also encompasses exchanged-based contracts such as sale (Iqbal and Mirakhor, 2011). Before we look at the definition of risk sharing, let's examine the meaning of risk from Islamic perspective.

The word risk or “*khaṭar*” and “*mukhāṭarah*” in Islamic law have been used with different connotations such as *gharar* (Malik, 2004), *murāhanah* (Hammad, 2008), *muqāmarah* (Malik, 2004) and the possibility of loss or profit in a particular transaction (Qayyim, 1994). Risk in Islamic law is always associated with the legal maxims (*qawā'id fiqhiyyah*) that emphasize on the direct and proportional relationship between the risk and return (El-Gari, 2003). These maxims include “*al-kharāj bi al-ḍamān*”, and “*al-ghurmu bi al-ghunm*”. While the former signifies that “a person is held liable in case an asset is damaged deserves to take its benefit as compensation” (Laldin et. al, 2013, p. 156), the latter maxim denotes that “one who expects profit must accept responsibility in case of loss” (Laldin et. al, 2013, p. 161). On the basis of these maxims and the prohibition of the Prophet (pbuh) on earning profit without bearing any liability or risk, scholars disallow the creditor in a loan contract to take any excess above the loan principal as he does not bear any risk. Similarly, if the *rabb al-māl* stipulates that the *muḍārib* in a *muḍārah* contract bears the liability for any financial loss from the venture, Ḥanafī scholars view that the *muḍārib* becomes entitled to all the profits for it takes the ruling of a loan contract (al-Kasani, 1986).

However, Elgari (2003) argued that the terminology of “*khaṭar*” as understood in the modern financial transactions is different from what was meant by the early Muslim jurists when they discussed about risk in contracts such as *shirkah*, *muḍārabah*, *salam*, *istisna’* and so on. Despite these contracts have the element of risk sharing or risk transfer, “the economic circumstances prevailing in those days and the methodology adopted for contracts did not attach the significance to the idea that is given in modern financial transactions” (El-Gari, 2003, p. 11).

Nonetheless, the discussion on risk from the economic and finance perspectives is not the main focus of this paper. Rather, the paper tries to establish the concept of risk in Islamic law of contract, particularly *mushārahah*, and later examines as whether it has been transferred to or shared among the contracting parties (i.e. partners).

Based on the definition of risk discussed above, it is evident that risk sharing in Islamic law refers to mutual risk bearing by the contracting parties involved in Islamic commercial transactions, which do not only limit to partnership-based contracts like *mushārahah* and *muḍārabah*. Rather, it encompasses debt-based contracts such as *murābahah* and *salam*. In all these contracts, the contracting parties have to take risk in order to gain profit. Nonetheless, risk sharing element is absent in a loan contract as the creditor does not assume any risk except default on the part of debtor. On this basis, many contemporary scholars promote risk sharing instruments, particularly *mushārahah* as the alternative to the interest-based and even the debt-based systems. Therefore, the proceeding sections will deliberate on the definition of *mushārahah* and its types, followed by the discussion of risk sharing features of this contract.

3. Definition of *Mushārah* and its Categories

The term *mushārah* has recently been introduced in the context of modern Islamic finance to describe a limited understanding of partnership, i.e. partnership in wealth. In this regard, Usmani (2002, p. 1) defines *mushārah* as “a joint enterprise in which all the partners share the profit or loss of the joint venture”. However, the term *shirkah* or *sharikah*, which connotes a wider meaning of partnership, is commonly used in the classical *fiqh* literature.

Generally, there are two main categories of partnership, namely joint ownership (*sharikah al-milk*) and contractual partnership (*sharikah al-‘aqd*). Each category has its own rules, conditions and sub-divisions, hence it is difficult to find a definition encompassing all partnership categories in *fiqh* literature. Nonetheless, some jurists try to include both categories in their definitions. For instance, al-Ramlī of Shāfi‘īs (1984, p. 5:4) defines *shirkah* or *sharikah* as “an established undivided right in a single thing or it is a contract implying this”, while Ibn Qudāmah - of Ḥanbalīs (1968, p. 5:3) mentions that: “Partnership is a participation in ownership and right of disposal (*taṣarruf*)”.

Sharikah al-milk refers to “the joint ownership of two persons [or more] in an *‘ayn* (ascertained thing) either through inheritance or sale” (Ibn Nujaym, n.d, p. 5:180). Therefore, *sharikah al-milk* is divided into two; automatic ownership via inheritance; and optional ownership via sale, gift, will, or charity.

On the other hand, *sharikah al-‘aqd* according to Mālikīs refers to: “permission by each of two partners to his companion for transacting for the one who gives permission [i.e. partner] and himself in wealth” (al-Dasuqi, n.d., p. 3:348). This

definition is claimed to include *sharikah al-‘inān*, *sharikah al-mufāwāḍah* and *sharikah al-wujūh*, yet excludes *muḍārabah*.

Meanwhile, Ḥanafīs define it as “an agreement between two or more persons for common participation in capital and profits” (Majallah al-Ahkam al-Adliyyah, n.d., p. 254). Nevertheless, a contemporary writer criticizes this definition as being limited to partnership with wealth (*sharikah al-amwāl*) only, thus excludes other types of *sharikah* such as partnership with work (*sharikah al-a ‘māl*) – also known as *sharikah al-abdān*, or *sharikah al-ṣanā’i ‘* or *sharikah al-taqabbul*, partnership with credit-worthiness (*sharikah al-wujūh*) and *muḍārabah* (Nyazee, 2006, p. 20), thus suggests a definition of *sharikah al-‘aqd* covering its various types as follows:

It is a contract between two or more people for participation in capital and profits, or participation in transactions in someone else’s capital and its profits, or participation in profit without participation in capital or transaction

Sharikah al-‘aqd is divided into several sub-categories. The Ḥanafīs sub-categorize it into three, namely: 1) *sharikah al-amwāl*, 2) *sharikah al-‘amāl* – also known as *sharikah al-abdān*, or *sharikah al-ṣanā’i ‘* or *sharikah al-taqabbul*, and 3) *sharikah al-wujūh*. Each of these categories is formed as *‘inān* and *mufāwāḍah* (al-Kasani, 1986, pp. 6: 56-57).

Ḥanbalī jurists classify the *sharikah al-‘aqd* into five types, namely: 1) *sharikah al-‘inān*, 2) *sharikah al- mufāwāḍah*, 3) *sharikah al-abdān*, 4) *sharikah al-wujūh* and 5) *muḍārabah* (Ibn Qudamah, 1968), whereas most Mālikīs² and Shāf‘īs take a similar

² However, some MÉlikÊs like al-DardÊr considers *muḍÉrabah* or *qirÉl* as a sub-set of *mushÉrakah*, yet he also devotes a specific chapter on it. Refer: al-DardÊr, *al-SharÍ al-KabÊr* & al-DasËqË, *al-×Éshiyah Ñala al- SharÍ al-KabÊr*, Beirut, DÊr al-Fikr, n.d., p. 3:351.

approach except that they consider *mudārabah* as an independent contract from *mushārah* (al-Ramli, 1984; Nyazee, 2006; Ibn Rushd, 2004).

While *sharikah al-amwāl* refers to an agreement between two or more persons for common participation in capital and profits, *sharikah al-a‘māl* means an agreement between two persons or more to accept a specific or unspecific type of work such as sewing and building; and the payment (*ujrah*) received will be divided according to the determined ratio (al-Muwsu‘ah al-Fiqhiyyah, 1404-1427). On the other hand, *sharikah al-wujūh* means “a participation of two persons who have no capital, yet they have credit-worthiness among the people, then both say: we participated so that we can buy with deferred [payment] and sell on spot. Whatever profit that Allah bestows will be between us based on certain condition” (al-Kasani, 1986, p. 6:57)

Based on the above, the term *mushārah* used in this section refers to a specific type of *sharikah*, i.e. *sharikah al-‘aqd* that includes three sub-categories based on Ḥanafīs, i.e. *sharikah al-amwāl*, *sharikah al-a‘māl* and *sharikah al-wujūh*, and four sub-categories based on majority, i.e. *sharikah al-‘inān*, *sharikah al-mufāwah*, *sharikah al-abdān*, and *sharikah al-wujūh*, but excludes *mudārabah*, as it will be discussed separately in the subsequent section. Accordingly, the terminology signifies a broader meaning compared to the definition given by Usmani (2002) who limits it to *sharikah al-amwāl*.

4. Features of Risk Sharing in *Mushārah* Contract

As mentioned earlier, risk sharing denotes mutual risk bearing among the contracting parties whereby each party bears the risks associated with the contract so that he becomes entitled to the profit. Therefore, the distinctive features of risk sharing in

mushārah contract lie in the bases for entitlement to profits and sharing of losses in *mushārah* contract. This particularly refers to the subjects of risk in *mushārah* contract and the prohibitive elements that arise from the violation of the fundamental risk associated with *mushārah* contract. In relation to this, relevant classical texts of Islamic jurisprudence are examined to highlight the features of risk sharing in *mushārah* contract.

a. Subject of Risk Sharing in *Mushārah* Contract

The discussion on the subject of risk sharing in *mushārah* contract is closely related to the opinions of Muslim scholars on the entitlement to profits and sharing of losses among partners. This is because “attaining profit is the objective of partnership” (al-Kasani, 1986, p. 6:68).

Accordingly, the paper shall examine the bases for the entitlement to profits in *mushārah* contract as expounded by different *fiqhi* schools. As Ḥanafīs and Ḥanbalīs have a similar view on this matter, the paper shall explain both views together, followed by the opinions of Mālikīs and Shāfiīs. The paper also sheds light on the basis for sharing losses in *mushārah* contract.

i. Bases for entitlement to profit according to Ḥanafīs and Ḥanbalīs

Ḥanafīs and Ḥanbalīs rely on the principle “يُسْتَحَقُّ الرَّبْحُ إِمَّا بِالْمَالِ أَوْ الْعَمَلِ أَوْ الضَّمَانِ” which means: “The entitlement to profit is either due to wealth (*māl*) or work (*amal*) or liability for bearing loss (*damān*)”.

In this regards, al-Kāsānī (1986, p. 6:62), a Ḥanafī jurist mentions:

وَالْأَصْلُ أَنَّ الرَّبْحَ إِنَّمَا يُسْتَحَقُّ عِنْدَنَا إِمَّا بِالْمَالِ وَإِمَّا بِالْعَمَلِ وَإِمَّا بِالضَّمَانِ، أَمَا تُبَوِّتُ الْإِسْتِحْقَاقَ بِالْمَالِ فَظَاهِرٌ؛ لِأَنَّ الرَّبْحَ نَمَاءُ رَأْسِ الْمَالِ فَيَكُونُ لِمَالِكِهِ، وَلِهَذَا اسْتَحَقَّ رَبُّ الْمَالِ الرَّبْحَ فِي الْمُضَارَبَةِ وَأَمَّا بِالْعَمَلِ، فَإِنَّ الْمُضَارِبَ يُسْتَحَقُّ الرَّبْحَ بِعَمَلِهِ فَكَذَا الشَّرِيكَ. وَأَمَّا بِالضَّمَانِ فَإِنَّ الْمَالَ إِذَا صَارَ مَضْمُونًا عَلَى الْمُضَارِبِ يُسْتَحَقُّ جَمِيعَ الرَّبْحِ، وَيَكُونُ ذَلِكَ بِمُقَابَلَةِ الضَّمَانِ خَرَجًا بِضَمَانٍ

Meaning:

The original [ruling], in our opinion, is that entitlement to profit is either due to wealth (*māl*) or work (*amal*) or liability for bearing loss (*damān*). As for the entitlement to wealth it is obvious, because profit is a growth in wealth and belongs to its owner. It is for this reason that the *rabb al-māl* in a contract of *muḍārabah* is entitled to profit and like-wise the partner. In the case of liability for bearing loss (*damān*), if the *muḍārib* were made to bear the liability for loss, he would be entitled to the entire profit (of the *muḍārabah*). This is due to his *damān*. Thus, if the liability for bearing loss falls on him, the *kharāj* belongs to him too.

Meanwhile, Ibn Qudāmah (1968, p. 5:6) of Hanbalīs mentions reasons for entitlement to profit as follows:

أَنَّ الضَّمَانَ يُسْتَحَقُّ بِهِ الرَّبْحُ، بِدَلِيلِ شَرَكَةِ الْأَبْدَانِ، وَتَقْبُلِ الْعَمَلِ يُوجِبُ الضَّمَانَ عَلَى الْمُتَقَبَّلِ، وَيَسْتَحَقُّ بِهِ الرَّبْحَ، فَصَارَ كَتَقْبِيلِهِ الْمَالَ فِي الْمُضَارَبَةِ، وَالْعَمَلُ يُسْتَحَقُّ بِهِ الْعَامِلُ الرَّبْحَ كَعَمَلِ الْمُضَارِبِ، فَيُنزَلُ بِمَنْزِلَةِ الْمُضَارِبَةِ

Meaning:

Ḍamān is a basis for entitlement to profit on the argument of *sharikat al-‘abdān* (work partnership). The acceptance of work involves *Ḍamān* for the person accepting work (as an independent contractor) and provides a basis for entitlement to profit. It is therefore, similar to the acceptance of wealth in *muḌārabah*. The worker is entitled to profit through his work; it is thus like *muḌārabah*.

He also writes (Ibn Qudamah, 1968, p. 5:23):

أَنَّ الْعَمَلَ مِمَّا يُسْتَحَقُّ بِهِ الرَّبْحُ، فَجَازَ أَنْ يَنْفَاضَلَ فِي الرَّبْحِ مَعَ وُجُودِ الْعَمَلِ مِنْهُمَا، كَالْمُضَارِبِينَ لِرَجُلٍ وَاحِدٍ، وَذَلِكَ لِأَنَّ أَحَدَهُمَا قَدْ يَكُونُ أَبْصَرَ بِالتَّجَارَةِ مِنَ الْآخَرَ، وَأَقْوَى عَلَى الْعَمَلِ، فَجَازَ لَهُ أَنْ يَشْتَرِطَ زِيَادَةَ فِي الرَّبْحِ فِي مُقَابَلَةِ عَمَلِهِ، كَمَا يَشْتَرِطُ الرَّبْحُ فِي مُقَابَلَةِ عَمَلِ الْمُضَارِبِ. يُحَقِّقُهُ أَنَّ هَذِهِ الشَّرْكَةَ مَعْفُودَةٌ عَلَى الْمَالِ وَالْعَمَلِ جَمِيعًا، وَلِكُلِّ وَاحِدٍ مِنْهُمَا حِصَّةٌ مِنَ الرَّبْحِ إِذَا كَانَ مُفْرَدًا، فَكَذَلِكَ إِذَا اجْتَمَعَا، وَأَمَّا حَالَةُ الْإِطْلَاقِ، فَإِنَّهُ لَمَّا لَمْ يَكُنْ بَيْنَهُمَا شَرْطٌ يُقَسِّمُ الرَّبْحَ عَلَيْهِ، وَيَتَّقَدَّرُ بِهِ، فَدَرَنَاهُ بِالْمَالِ، لِعَدَمِ الشَّرْطِ، فَإِذَا وُجِدَ الشَّرْطُ، فَهُوَ الْأَصْلُ، فَيَصِيرُ إِلَيْهِ

Meaning:

Work (*‘amal*) is a basis for entitlement to profit. It is therefore, allowed for both partners to have excess in profit when there is work from them, like in *muḌārabah* for one person. As one of them can be more expert in trading and stronger in work compared to the others, hence, he can stipulate excess in profit for his work, similar to stipulation of profit against the work of *muḌārib*. This partnership [i.e. *sharikah al-‘inān*] is done based on both wealth and work, thus each partner is entitled to profit even [the work] is done by only one partner or both. When there is no stipulation, then the profit is divided among them according to capital contributions. However, when there is stipulation, it is therefore the original [ruling] and should be based on it.

The above statements of Ḥanafīs and Ḥanbalīs indicate that both *fiqhī* schools permit entitlement to profit based on three factors: wealth, work and liability for bearing loss. Based on these reasons, they allow *sharikah al-amwāl*, *sharikah al-a'māl* and *sharikah al-wujūh*, and permit excess profit for excess work, except that Ḥanbalīs allows the excess of profit to be merely based on stipulation (if any), regardless whether the partner is a working or sleeping partner.

Ḥanafīs, on the other hand, allows for the partners to stipulate that profit can be in proportion to the capital contribution or in excess of it, whether the work is stipulated for one partner or both (al-Kasani, 1986), but the excess of profit should be limited to the following scenarios:

- i. If the capital contributions are unequal and the work is stipulated for one partner only while the profits are shared in proportion to the capital, the stipulation is valid. However, if the excess is stipulated for the sleeping partner, the stipulation is invalid (Nyazee, 2006).
- ii. If the capital contributions are equal and the work is stipulated only on the partner who receives an excess profit, the stipulation is valid because the entitlement to profit is due to his wealth and extra work done. On the other hand, if the work is stipulated only on the partner who receives less profit, the stipulation is invalid (Majallah al-Ahkam al-Adliyyah, n.d., pp. 263-264) because the one who receives more profit is not entitled to it due to absence of wealth, work and liability for bearing loss (al-Kasani, 1986).
- iii. If the capital contributions are unequal and the work stipulated is proportionate to the contributions (i.e. more work for the partner with more capital), but the excess profit is stipulated for the partner who contributes less capital and does less work, the stipulation is invalid (Nyazee, 2006).

Sharikah al-wujūh has been allowed by Ḥanafīs based on pure *ḍamān* (Nyazee, 2006) (i.e. liability for the price of goods purchased on deferred) upon the share of ownership in the property purchased that each partner has to bear³, as there is neither wealth nor work involved in this type of partnership. Accordingly, when profit is stipulated to a partner more or less than the *ḍamān al-milk* that he has to bear, then the stipulation is invalid as excess in work in this category of partnership has no effect for entitlement to profit. In this regard, al-Sarakhsi (1993, p. 11:154) says:

أَنَّ فِي هَذَا الْعَقْدِ لَا يَصِحُّ التَّفَاضُلُ فِي اسْتِزَاطِ الرِّبْحِ بَعْدَ التَّسَاوِي فِي مِلْكِ الْمُشْتَرِي؛ لِأَنَّ الَّذِي يُسْتَرْطُ لَهُ الزِّيَادَةُ لَيْسَ لَهُ فِي نَصِيبِ صَاحِبِهِ رَأْسُ مَالٍ وَلَا عَمَلٍ وَلَا ضَمَانٍ. فَاسْتِزَاطُ جُزْءٍ مِنْ ذَلِكَ الرِّبْحِ لَهُ يَكُونُ رِبْحٌ مَا لَمْ يُضْمَنْ، وَتَهَى رَسُولُ اللَّهِ - صَلَّى اللَّهُ عَلَيْهِ وَسَلَّمَ - عَنْ ذَلِكَ، فَإِنْ أَرَادَ التَّفَاوُتَ فِي الرِّبْحِ فَيَنْبَغِي أَنْ يُسْتَرْطَ التَّفَاوُتَ فِي مِلْكِ الْمُشْتَرِي؛ بِأَنْ يَكُونَ لِأَحَدِهِمَا التُّلُثُ، وَلِلْآخَرِ التُّلُثَانِ؛ حَتَّى يَكُونَ لِكُلِّ وَاحِدٍ مِنْهُمَا الرِّبْحُ بِقَدْرِ مِلْكِهِ

Meaning:

In this contract, a stipulation of profits in excess (over the ratio of ownership) is invalid when there is equality of ownership in the thing purchased. The reason is that this excess is not linked either to the share of the partner in wealth or to his work or to *ḍamān*. Stipulating such a part of profits will amount to something that is not supported by liability. The Prophet has prohibited this. If an excess of profits is desired, it is necessary to stipulate a corresponding excess in ownership of the purchased goods (and thus in the liability to bear loss). This way, it may be, that a third is for one partner and

³ In this regards, The Majallah al-AíkĒm al-ÑAdliyyah (n.d., p. 270) states that:

المادة (1400) استحقاق الربح في شركة الوجوه إنما هو بالضمان.
المادة (1401) ضمان ثمن المال المشتري يكون بنسبة حصّة الشريكين فيه

Meaning: Article (1400) The entitlement to profit in *sharikah al-wujĒh* is based on *İamĒn*

Article (1401) *ÖamĒn* for the price of the purchased asset is based on the share of partners in it (i.e. price)

two-third for the other, and thereafter the other profits may be shared in proportion to the ownership.

ii. Bases for entitlement to profit according to Mālikīs

Mālikīs are of the view that a partner is entitled to profit on the basis of wealth contributed to the partnership. Imām Malik (1994, p. 3:605) says:

“الْوَضِيعَةُ عَلَى قَدْرِ رُءُوسِ أَمْوَالِهِمَا، وَالرِّبْحُ عَلَى قَدْرِ رُءُوسِ أَمْوَالِهِمَا”

Meaning: “*Loss is based on the capital of partners, and profit is based the capital of partners*”

Ibn Rushd (2004, p. 4:37) affirms this opinion by saying “the third element is work (*amal*) and it is subservient according Mālik, as we said, to wealth and is not treated as an independent basis. According to Abū Hānifah, it is treated as an independent basis with wealth”.

Nevertheless, Nyazee (2006) argued that when work is not dependent on wealth, it can be regarded a valid basis for entitlement to profit according to Mālikīs. However, if wealth accompanies labour, it becomes subservient to wealth. This is based on the permissibility of *sharikah al-abdān* by Mālikīs. The author of *al-Mudawwanah al-Kubra* (Sahnun, pp. 5:42-43) says that “What do you think, if two persons participate with labour, and they are butchers who do not need capital ... There is no harm in this, like partnership in *dirhams*, because when they participate with manual labour, such labour is considered a substitute for *dirhams*. Thus, whatever is valid for *dirhams* is valid for manual work”.

With regards to *damān*, Mālikīs do not consider it as an independent basis for entitlement to profit, thus prohibit *sharikah al-wujūh*.

iii. Bases for entitlement to profit according to Shāfi‘īs

Partnership according to Shāfi‘īs confines to partnership in wealth only. The basis for entitlement to profit is limited to wealth only, similar to loss. Hence, they do not allow *sharikah al-abdān* and *sharikah al-wujūh*. Al-Sharbīnī (1994, p. 3:227) says: “Profit and loss are based on the capital contributions”.

As for *muḍārabah*, which is based upon work from one side, they allow it as a type of *ijārah*, not as a partnership (Nyazee, 2006).

iv. Basis for sharing losses in *mushārah* contract

Apart from profits, *mushārah* partners should also be liable to share losses. Scholars unanimously agree that each *mushārah* partner should bear the loss in proportion up to their capital contribution only. This is based on the following saying of companions (*āthār*):

الرِّبْحُ عَلَى مَا اصْطَلَحُوا عَلَيْهِ، وَالْوَضِيعَةُ عَلَى الْمَالِ

“Profit is based on the agreement of the parties, but loss is always subject to the ratio of investment” (al-San‘ani, 1403H, p. 8:248).

Accordingly, if a partner contributes 40% of capital, for example, then he should not suffer the loss more, or less than his contribution. Therefore, it is impermissible to agree that “one partner or a group of partners liable for the entire loss or liable for a

percentage of loss that does not match their share of ownership in the partnership. It is, however, valid that one partner takes, without any prior condition, the responsibility of bearing the loss at the time of the loss” (AAOIFI, 2010, p. 207).

Analysis

Based on the above discussion, it is apparent that jurists have different opinions regarding the subject of risk in *mushārah* contract. While Shāfi‘īs and Zufar from Ḥanafīs view that the entitlement to profits and sharing of losses is based on wealth (*māl*) only, Malikīs opine that profit and loss sharing can be based on wealth (*māl*) and work (*‘amal*). On the other hand, subject of risk sharing in the *mushārah* contract, according to Ḥanafīs, includes wealth (*māl*), work (*‘amal*), and liability for bearing loss (*ḍamān*).

Nevertheless, a closer look at both classical and modern texts on the issue reveals that *māl* or *‘amal* alone cannot be independent bases for the entitlement to profit; rather they should be coupled with *ḍamān*. For instance, in the case of *sharikah al-a‘māl*, the Majallah al-Aḥkām al-‘Adliyyah (n.d., p. 268) clearly specifies:

الشَّرِيكَانِ يَسْتَحِقَّانِ الْأَجْرَةَ بِضَمَانِ الْعَمَلِ، فَلِذَلِكَ إِذَا لَمْ يَعْمَلْ أَحَدُهُمَا لِمَرَضِهِ أَوْ لِدَهَابِهِ إِلَى مَحَلٍّ أَوْ لِفُعُودِهِ عَنِ الْعَمَلِ وَعَمَلَ شَرِيكُهُ فَقَطْ فَيُقَسَّمُ الْكَسْبُ وَالْأَجْرَةُ الْحَاصِلَةُ عَلَى الْوَجْهِ الَّذِي شَرَطَاهُ أَيْضًا.

Meaning: “Two partners are entitled to fee due to the liability to deliver the work. Therefore, if one of the partners does not even do any work due to his illness or his travelling to somewhere else, or his failure to work and only one partner works; the return and fee derived (from the venture) is still divided according to what has been agreed by both parties”.

In addition, al- Kasani (1986, p. 6:76) mentions:

وَيَجُوزُ شَرْطُ التَّفَاضُلِ فِي الْكَسْبِ، إِذَا شَرَطَ التَّفَاضُلَ فِي الضَّمَانِ، بِأَنْ شَرَطَا لِأَحَدِهِمَا ثُلُثِي الْكَسْبِ، وَهُوَ الْأَجْرُ، وَالْآخِرِ الثُّلُثُ وَشَرَطَا الْعَمَلَ عَلَيْهِمَا كَذَلِكَ، سِوَاءَ عَمَلِ الَّذِي شَرَطَ لَهُ الْفَضْلَ أَوْ لَمْ يَعْمَلْ بَعْدَ أَنْ شَرَطَا الْعَمَلَ عَلَيْهِمَا؛ لِأَنَّ اسْتِحْقَاقَ الْأَجْرَةِ فِي هَذِهِ الشَّرِكَةِ بِالضَّمَانِ لَا بِالْعَمَلِ بِدَلِيلِ أَنَّهُ لَوْ عَمَلَ أَحَدُهُمَا اسْتَحَقَّ الْآخَرَ الْأَجْرَ، وَإِذَا كَانَ اسْتِحْقَاقُ أَصْلِ الْأَجْرِ بِأَصْلِ ضَمَانِ الْعَمَلِ لَا بِالْعَمَلِ، كَانَ اسْتِحْقَاقُ زِيَادَةِ الْأَجْرِ بِزِيَادَةِ الضَّمَانِ، لَا بِزِيَادَةِ الْعَمَلِ

Meaning: “The stipulation of excess in profit is allowed if (the partner) stipulates an excess in *damān*; as if both partners stipulate that one of them is entitled to two-third of the return while the other partner gets one-third of it and they also stipulate the work on both partners, regardless whether the one who gets the excess profit works or not after both stipulate the work on themselves. This is because the entitlement to profit in this type of partnership is based on *damān* not *amal*, for if only one partner works the other partner is also entitled to profit. When the entitlement to the profit is based on *damān al-amal* not *amal* alone, the entitlement to the additional profit is based on the additional *damān* not *amal*.”

In *sharikah al-amwāl*, on the other hand, the original ruling for the entitlement to profits and sharing losses is due to *damān* that each partner can provide according to his proportion of capital contributions. However, Ḥanafīs and Ḥanbalīs allow the profit sharing ratio to be different from the capital contributions based on stipulations agreed among the partners.

If *māl* or *amal* should be coupled with *damān* for the entitlement to profit, the question asked is: can pure *damān* be a basis for the entitlement to profit as in the case of *sharikah al-wujūh*? Or, does *damān* in *sharikah al-wujūh* actually relate to *damān al-māl*? From the definition given by its proponents, *damān* in *sharikah al-wujūh* is

related to the share of ownership in the property purchased on deferred payment (*ḍamān thaman al-māl al-mushtarā*). Therefore, *ḍamān* in *sharikah al-wujūh* is indirectly related to *māl* in its general meaning, not *māl* that specifically relates to the capital contributions as in *sharikah al-amwāl*.

b. Violation of Fundamental Risk in *Mushārah* Contract

Mushārah contract is based on trust (*amānah*), where each partner is considered a trustee to one another like in the safe-keeping (*wadī'ah*) contract. The general principle in all trust-based contracts is that no liability except in the case of negligence or misconduct. Therefore, so long as the partner observes the terms and conditions of the contract, and does not get involved with negligence or misconducts, he shall not be liable for any losses of his partner's share of capital (Al-Zuhayli, 1997). Accordingly, there should not be any element of guarantee of capital nor profit in *mushārah* as it violates the essence of the contract. If, however, capital is guaranteed in *mushārah* contract and all profit is stipulated to one partner only, the contract is no longer considered as *mushārah*, rather; it is ruled as a loan (*qard*) contract. Hence any increase over and above the capital will be tantamount to *ribā*.

Ibn Humām (n.d., p. 6:178) mentions that:

لَوْ شُرِّطَ كُلُّ الرَّبْحِ لِأَحَدِهِمَا فَإِنَّهُ لَا يَجُوزُ؛ لِأَنَّ الْعَقْدَ حِينَئِذٍ يَخْرُجُ عَنِ الشَّرِكَةِ وَالْمُضَارَبَةِ أَيْضًا إِلَى قَرْضٍ إِنْ شُرِّطَ لِلْعَامِلِ، كَأَنَّهُ أَقْرَضَهُ مَالَهُ فَاسْتَحَقَّ جَمِيعَ رِبْحِهِ، وَإِلَى بَضَاعَةٍ إِنْ شُرِّطَ لِرَبِّ الْمَالِ

Meaning: If the entire profit is stipulated for one of them, it is not permitted, because the contract has thereafter moved out from the domain of *sharikah* and *muḍārabah*, and becomes *qarḍ* if the [profit] is stipulated to the worker. It is as if he [i.e. *rabb al-māl*] has given him his wealth as *qarḍ* so that he [i.e. the worker] may have the whole profit, and it becomes *biḍā'ah* [or *ibḍā'*], if it is stipulated for the *rabb al-māl*.

In addition, the majority of Muslim jurists ruled that *mushārah* is a non-binding contract (*'aqd jā'iz*), in which each partner is entitled to terminate the partnership without attaining consent from the other partner. Nevertheless, as *mushārah* has an element of agency (*wakālah*) Ḥanafīs opine that the partner who wants to terminate the contract should notify the other partner in order to avoid any harm to the latter, otherwise his termination is invalid (Al-Zuhayli, 1997).

5. Contemporary Applications of *Mushārah* Contract

Mushārah has been used as an underlying Sharī'ah principle in different sectors of contemporary Islamic finance, namely Islamic private equity (PE) and venture capital (VC) in Islamic investment, *ṣukūk* in Islamic capital market, home financing, particularly *mushārah mutanāqishah* in Islamic banking.

While some of these contemporary applications are in line with the essence of *mushārah* contract that lies in attaining profits and sharing losses, some have been criticized as behaving like a debt-based financing, hence mirroring the conventional ethos.

Islamic PE and VC⁴ is an example of financing modes that adhere to the true spirit of *mushārah* as the capital provider who invests in the business venture becomes a partner with the operator of the business. Hamzah (2011, p. 40) states that:

Venture capital and private equity are very compatible with the fundamental principles of Islamic finance because the provider of capital holds an equity interest in the firm and becomes involved in its success or failure at a relatively early point in the company's life... Both the company and the private equity provider share the same risks for profit and loss as the company grows

Nonetheless, this mode of financing has received less interest compared to ones offered by the banking sector, particularly debt-based financing such as *murābahah* as Islamic PE and VC are based on absolute profit and loss sharing, thus emphasizing on the risk sharing.

Although the spirit of risk sharing is duly adhered in Islamic PE and VC, the application of *mushārah* contract in *ṣukūk* investment has received considerable criticism from many Sharī'ah scholars. In February 2008, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued a Sharī'ah pronouncement unequivocally declaring that *ṣukūk* are inherently different from conventional bonds, thus all equity-based *ṣukūk* issuances, i.e. *mushārah*, *muḍārah* and *wakālah ṣukūk* should not compromise the basic rules of equity

⁴ The investment involves either buying companies or taking equity shares of the ventures, improving their performance and selling it off for a profit. In US terminology, venture capital (VC) is a subdivision of private equity (PE), where VC refers to the early stage of investments and expanding companies, while PE tends to involve more mature investee companies. Both aims at investing in companies that investors regards as potentially profitable, and then exiting from the investment after a period of time to gain returns. Nevertheless, in Europe terminology, VC connotes the same meaning as PE. See: Zaid Hamzah, *Islamic Private Equity and Venture Capital: Principles and Practice*, Kuala Lumpur: IBFIM, 2011, p. 3 & p. 23

contracts to meet the characteristics of fixed income investments, where capital is protected and risk of loss is minimized. Therefore, the AAOIFI (2008) outlines that:

Third: It is not permissible for the Manager of Sukuk, whether the manager acts as Mudarib (investment manager), or Sharik (partner), or Wakil (agent) for investment, to undertake to offer loans to Sukuk holders, when actual earnings fall short of expected earnings...

Fourth: It is not permissible for the Mudarib (investment manager), Sharik (partner), or Wakil (agent) to undertake {now} to re-purchase the assets from the Sukuk holders or from one who holds them, for its nominal value, when the Sukuk are extinguished, at the end of its maturity. It is, however, permissible to undertake the purchase on the basis of the net value of assets, its market value, fair value or a price to be agreed, at the time of their actual purchase...

This pronouncement was issued in relation to the use of various credit enhancement mechanisms, particularly the liquidity facility arrangement and purchase undertaking at a fixed formula and incentive fees, to replicate the fixed income features of conventional bonds in *mushārah* and *muḍārahah ṣukūk* issuances. These credit enhancements have been introduced to attract the investors who are risk-averse and thus expect capital protection and fixed returns similar to bonds instruments. (Dusuki, 2010).

Nonetheless, the practice has violated the fundamental feature of risk sharing in either *mushārah*, *muḍārahah* or *wakālah* contract. As indicated earlier, any form of guarantee to the capital and return in *mushārah* or *muḍārahah* will transform the contract into loan. In addition, profits distributed to the *mushārah*, *muḍārahah* and

wakālah partners should depend on the actual returns, hence can be variable. Accordingly, if the periodical distributions to the Sukuk holders in *mushārahah*, *muḍārahah* and *wakālah ṣukūk* are fixed, the excess profit received will tantamount to something that is not supported by liability.

6. Conclusion

After a close scrutiny to the concept of risk sharing in Islamic law, the study discovered that the concept has been discussed by the early Muslim jurists in the context of various Islamic financial contracts which includes both equity-based and debt-based. The bases underpinning this concept are the legal maxims that promote proportional relationship between the risk and reward and the prohibition of the Prophet from gaining profit without taking any liability.

The study revealed that the distinctive features of risk sharing in *mushārahah* contract lie in the bases for entitlement to profits and sharing of losses as both are the essence of the contract. Accordingly, the study found that there should not be any element of guarantee of capital nor profit in *mushārahah* as it violates the essence of the contract. If, however, capital is guaranteed in *mushārahah* contract and all profit is stipulated to one partner only, the contract is no longer considered as *mushārahah*, rather; it is ruled as a loan (*qarḍ*) contract. Hence any increase over and above the capital will be tantamount to *ribā*.

In terms of the application of *mushārahah* contract in the contemporary Islamic financial transactions, the study suggested that there are some practices that are not in line with the true spirit of risk sharing in *mushārahah*. Various permutations have

been embedded in the *mushārah*-based products so that the end results will replicated the debt-based instruments. It is therefore recommended that Islamic finance should adhere to the risk sharing features of *mushārah* contract for such adherence will promote justice and fairness to all contracting parties.

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