

## RISK FOR RETURN PRINCIPLE IN ISLAMIC CONTRACTS: two case studies

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## FACTORS JUSTIFYING RETURN OR PROFIT

- Work or labour provided (*ijarah, jualah, sharikah, mudharabah*): service provided
- Assumption of liability (*dhaman*) or guarantee (*sharikat al-wujuh*)
- Assumption of risk of loss of capital or asset
- *Al-Ghunmu bi'l ghurmi principle* (return for risk of liability)
- *Al-Kharaj bi al-Dhaman principle* (return for risk of loss)

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## RISK FOR RETURN IN MONEY-LENDING (QARD)

- Borrower takes the borrowed money with duty to repay in identical substitute
- Once received from the lender, borrower assumes ownership over the money
- Thus free to utilise in whatever way chosen
- Risk of loss is effectively passed to the borrower
- Hence any return generated from the use of the fund is halal or legitimate for the borrower ( risk for return )

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## THE POSITION OF LENDER

- Since the money lent is secured in the sense that the borrower must repay in whatever condition, there is no real risk for the lender
- Lender not entitled to charge interest/riba since ownership in the money has been passed on to the borrower who will bear risk of loss and at the same time under legal duty to repay the lender
- If lender is allowed to charge riba/interest, he will be unfair to the borrower who will: 1) have to bear risk of loss of the money and 2) repay the lender in whatever circumstances

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## CASE STUDY 1- AL ZUBAYR IBN AL-AWWAM

- Al-Zubayr ibn al-Awwam was a companion of the Prophet: one of ten who was promised paradise
- People always wanted to deposit their money with him (*wadiah*) for his honesty
- If he took it as *wadiah*, his liability would be fault-based had the money been lost while in his custody
- Meaning, with no negligence or wrongful doing on his part, the owner could not sue him for the loss
- Neither could the owner sue him for loss due to factors beyond human ability to guard against natural hazards or disasters

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## AI-ZUBAYR .....

- He however could not utilise the *wadiah* for his own purpose as a trustee
- What he did was asking the people to deposit the money with him as *qard/loan* instead as *wadiah*
- His legal position was thus changed to that of a borrower rather than a trustee
- As a borrower he assumed duty to repay the owner in whatever circumstances
- He also assumed ownership over the money and thus risk of loss was transferred to him
- As such it was legitimate for him to utilise the fund for his own purpose
- It was reported that he managed to make nearly 3 million dinars in the venture: this was halal return based on risk for return principle

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## CASE STUDY 2- THE TWO SONS OF CALIPH UMAR IBN AL-KHATTAB

- They were Abdullah and Ubaidillah who went to Iraq for some purposes
- When about to return to Medina, Abu Musa, the Governor of Iraq approached them to help him transfer public fund to the capital
- He suggested that he would lend them the fund so that they could buy goods to be purchased in Iraq and sold in Medina for profit and pay the Caliph the amount so borrowed
- Both agreed to the idea
- Legal position of parties: Benefit to the governor was security of transfer since the amount was secured i.e the two sons must repay the amount to the Caliph in whatever circumstances as it was loan/qard.
- Benefit to the two sons: since it was loan/qard they were free to utilise the fund for their own purpose
- They assumed risk of loss and liability to repay thus entitled to profit from the dealing: risk for return principle

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## THE APPLICATION OF THE PRINCIPLE

- They reached Medina and did what was planned
- They made good profit and sought audience with Caliph Umar to affect the transfer @ pay the original amount but wanted to keep the profit for themselves
- However the Caliph did not agree and wanted to take control of the whole sum (principle and profit)
- He feared that his sons were given special treatment by the governor due to his position as caliph.
- People in the audience argue it was not fair for the caliph to take such a stand since the two sons had assumed the risk of ownership by virtue of the loan arrangement entered into with the governor, thus entitled for return or profit associated with the use of the borrowed fund.
- They however settled for 50:50 share of profit based on mudharabah principle

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## RISK FOR RETURNS PRINCIPLE IN SALE OF GOODS

- In sale of goods (al-bai'), once the contract is concluded, ownership in the goods is theoretically transferred to the buyer
- However the Shariah recognises certain types of options/khiyar to the buyer or seller or both
- The contract is thus enforceable subject to the relevant party exercising this right
- What happens to the goods pending finalisation of the deal?
- Who shall bear risk of loss due to natural elements or disasters *i.e factor beyond human ability to guard against?*
- Is it the buyer or the seller?

## WHO OWNS THE GOODS?

- Jurists of Islamic schools of law (mazahib) differ in their opinions
- View I: to the buyer, so any increment or return belongs to him since as owner he bears risk of loss
- View II: to the seller so any increment or return belongs to him since as owner he bears risk of loss
- View III: Legal ownership is suspended pending finalisation of option

## WHO BEARS RISK OF LOSS OF GOODS DURING PERIOD OF OPTION?

- If loss occurred while in seller's position, he bears the consequence and the contract is dissolved (frustration of contract) and the option is of no effect
- However for loss occurred after the buyer has taken delivery of the goods, there are several views of jurists
- To the Maliki school: the seller shall bear the consequence since pending finalisation of option the buyer only takes possession as a trustee i.e does not bear risk of loss as an owner. As such with no negligence or wrongful doing he can not be held accountable for the loss whether the option is for the benefit of one of the parties or both
- For the Hanafi, if the option is for the benefit of the buyer, he shall bear the loss and he needs to pay the price to the seller: risk for return

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## CONTINUATION.....

- If the option is for the benefit of the seller, the buyer needs to pay the market value of the lost goods to the seller not its price
- To the Shafii school: the buyer is liable to pay the market value of the lost goods to the seller if the option is for the benefit of the seller or both
- If however the option is for the benefit of the buyer he bears the loss and liable to pay the price to the seller
- As seen: benefit of option must come with readiness to bear loss (no risk no gain)

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## **RISK AND RETURN IN MUDHARABAH. Profit-sharing based on trust**

- *Mudharabah* as a type of *Sharikah*
- *Mudharabah* as trust financing distinct from either equity or debt financing for business
- Capital provided by one party with management left entirely to the other
- Capital provider @ investor is entitled for share of profit since he assumes risk of loss of capital
- Not allowed to insert term that gives full protection to fund invested

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## **RIGHTS AND OBLIGATIONS OF PARTIES IN MUDARABAH**

- *Mudharib* acts as agent to capital provider thus his liability is based on fault principle (*bitta' addi*)
- Once the undertaking is profitable he becomes partner to the capital provider in relation to profit so generated, based on agreed ratio: share of profit based on service/work rendered
- If commits breach of conditions or be negligent he is strictly liable for loss or diminution of capital: dispute on return gained after breach: the Hanafi school says return should belong to the *mudharib* since by the breach he is strictly liable for loss of capital
- He has no right to incur liability in excess of capital unless with express authorization from capital provider
- If for some reasons the *mudharabah* becomes *fasid* (voidable) he is entitled for fair remuneration (*ujrat al-mithl*)

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## RISK AND RETURN IN MUSHARAKAH: PREFERENCE SHARE

- In Musharakah the general rule is that loss is to be shared based on ratio of capital invested, return based on percentage as agreed
- As loss is defined as reduction in original capital so apportionment must be in *pari passu* with amount invested
- Preference share gives special treatment to holders in respect of 1) priority in dividend payment 2) priority in capital reimbursement upon dissolution of the company/sharikah@winding-up ( partial protection of capital)
- Since no full risk of loss of capital as compared to ordinary shares, PSs are held not permissible according to the majority view of contemporary jurists as the practice is not in line with risk for return principle

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TERIMA KASIH

WASSALAM

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