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# A Property Theory of Islamic Finance

# نظرية الملكية في المالية الإسلامية

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## Abstract
This paper emphasizes that Islamic finance took the sale, lease, and sharing contracts from the commercial laws and made them the core of financial intermediation and banking. It ponders the nature and common features of the three general financing methods through sale, lease, and sharing to reveal the basis of Islamic finance. The paper mainly adopts qualitative research methodologies, namely literature review and content analysis. It starts with the experiences of early Islamic banks in terms of their financing methodologies and describes the risk-sharing theorem of Islamic finance. The statement that puts risk-sharing as the basis of Islamic finance and its distinguisher from interest-based finance is critically discussed, considering the fundaments and deficiencies of the theorem. The paper finally proposes a property theory of Islamic finance, which asserts that Shari'ah-compliant financing must always pass through ownership, and the Islamic bank must own utility-producing and added-value-generating real properties before giving them to its clients. Thus, ownership of increment-generating assets/goods is the justifier of return in Islamic finance. Consequently, Islamic finance is property-based and integrates financing into the production process. This feature makes its earnings derived from the added value and gives the earnings in Islamic finance a moral and rational base, lacking in interest-based finance. This paper is novel in proposing ownership of real properties as a new basis of Islamic finance, which is fundamental, inclusive, logically consistent, and applicable compared to the risk-sharing theorem of Islamic Finance.
**Keywords**: Islamic Finance, Return, Risk-sharing, Ownership, Property-based, Added-value

## 1. Introduction
One of the earliest contemporary experiments in Islamic finance was the Mit Ghamr saving/investment organization, which was known among writers on Islamic banking and finance as the first Islamic Bank. The organization was established by an economist, Ahmed Al-Najjar, in a small village located in the Northern part of Egypt and operated between 1963 and 1967. The bank collected small savings from village residents, with a population of about 5,000 at most, and financed local businesspeople in the same neighborhood. Both the mobilization and disbursement processes were based on mudarabah.

Contemporary Islamic finance literature, especially in Arabic, has several writings on the Mit Ghamr experiment, including those by the late professor Ahmed Al-Najjar himself. This early literature considered the Mit Ghamr saving/investment organization the first Islamic bank, although another example of an Islamic finance organization existed before or just around the same time as the Mit Ghamr, the Tabung Haji Fund in Malaysia, which was explored later. Since the Mit Ghamr functioned on the basis of mudarabah on both sides of the transaction, the idea of risk-sharing has become dominant in the literature, and the mark-up mechanism has been neglected, as acknowledged by Khan [1]. According to many writers, the main principle of Islamic banking must be risk-sharing, and the literature is still chanting the concept of risk-sharing as the basis of Islamic finance today. Similarly, the dependence of Islamic banking mainly on murabahah in terms of fund disbursement has been criticized, sometimes even considered a deviation of Islamic banks away from the appropriate path [2].

This paper argues that ownership is the basis of Islamic finance, in general, and the only justifier of earning return on finance provision in particular. This implies negating the statement that puts risk-sharing as the basis of Islamic finance and its distinguisher from interest-based finance. In line with this proposition, the paper mainly adopts qualitative research methodologies, namely literature review and content analysis, and is structured as follows. After this introduction, the second section presents the early contemporary Islamic banking experiences other than the Mit Ghamr, as well as the introduction of murabahah in Islamic banking as a main tool for fund disbursement and its dominance over alternatives. The third section briefly explains the risk-sharing theorem, discusses its misconceptions about risk, and then elaborates on why risk-sharing is not appropriate to be the basis of Islamic finance and banking. After discussing the nature and origins of the financial instruments of Islamic banks and their common features, the fourth section argues that ownership is the basis of earning and also the foundation for Islamic finance and banking. Finally, the paper ends with the concluding remarks in the fifth section.

## 2. Early Islamic Banks and The Introduction of Murabahah

### 2.1. Experiences of Early Islamic Banks

The Mit Ghamr experiment in Egypt led to the adoption of the idea that Islamic finance should be based on risk-sharing because it was really an organization collecting savings from earners of small incomes and giving them for investment to known local community small shopkeepers and craftsmen on the basis of mudarabah. Historically, it was considered an early experiment in Islamic banking. Thus, it was thought that Islamic banks must always give funds on a mudarabah basis. However, there are other examples of early Islamic banks besides the Mith Ghamr saving/investment organization. This section presents a brief history of the contemporary Islamic banking sector to analyze the reasons for introducing murabahah-based fund disbursement in Islamic banks through a historical narrative.

Tabung Haji, another contemporary Islamic banking experience, started its journey in 1959 with the proposal of a Malay economist, Ungku Aziz bin Ungku Abdul Hamid. The first official step was taken in 1962, and the Hajj Provident Fund Corporation, which was transformed into Tabung Haji after its merger with the Hajj Affairs Management Office, started its operations in 1963 in Kuala Lumpur,

[1] *An Analysis of Risk Sharing in Islamic Finance with Reference to Pakistan* (Loughborough University, Doctoral Thesis, 1996).

[2] Mehmet Asutay, "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," *Asian and African Area Studies* 11/2 (2012), 98–99.

Malaysia [1]. Thus, Tabung Haji was established approximately one year before the Mit Ghamr. However, its discovery by scholars and institutions in the Islamic economics and finance field came many years later, at the beginning of the 1990s. As a matter of fact, the Islamic Development Bank (IsDB) awarded Tabung Haji its prestigious prize in Islamic banking and finance in 1990 [2].
Tabung Haji is not classified as a bank today, and it was never called a bank by the Malay people and authorities. It is a kind of corporate organization whose supervision and management assignments are undertaken by the government. Tabung Haji accepts deposits from those who intend to go for Hajj and invest them with the hope of making these savings grow in order to enable depositors to have higher financial means to pay for the expensive trip of Hajj. It also provides Hajj management services [3].
The collected funds in Tabung Haji were used on the basis of investment, such as creating or becoming a partner with companies. It never gave finance on murabahah at the early stages of its operations. It is because murabahah or sale financing was not known at that time, and the prevailing impression argues that Islamic finance should be based on risk-sharing. However, the current distribution of the total assets of Tabung Haji points to a change in the situation in this respect. Although Tabung Haji owns several companies in sectors such as agriculture, construction, health, tourism, etc., the share of income generated from foreign and private equities in its total gross income constituted only 20 percent in 2021. On the other hand, the percentage of its fixed incomes, which compromise returns on sale financing, was 52 percent for the same year [4].
The first commercial Islamic bank, Dubai Islamic Bank (DIB), was established and started its operations in 1975 [5].Kuwait Finance House (KFH) was the second commercial Islamic bank established in 1977 [6]. Two years after KFH, Jordan Islamic Bank (JIB) was founded and started its activities in 1979, but with a different concept and instruments [7].
The concept of risk-sharing as the core of Islamic finance was common among scholars and practitioners at the time when the early commercial Islamic banks started to be established in the 1970s. The only idea prevalent at that time was to give financing on risk-sharing, i.e., mudarabah and/or musharakah. The KFH and the DIB could not offer financing at all in the early years of their existence. This phenomenon stems from the nature of the local businesses. Since everyone in the market is a profit maximizer and wants to grab as much from the contracting partners, becoming a sleeping partner through mudarabah contracts, which are based on trust, cannot be the appropriate option for the Islamic banks being responsible for managing their depositors' funds efficiently, i.e., with utmost protection, safeguarding and profit maximization. This same nature of doing business, when applied to banking activities, prevented Islamic commercial banks from disbursing funds on mudarabah to businesses during the early stages of their existence.
The KFH and the DIB, which could not provide financing for the above reasons, started trading real estate properties. Both banks were about to declare bankruptcy because the real estate crisis led to a drop in real estate prices in the early 1980s. The founder of the DIB poured additional capital from his own

[1] Tabung Haji, "Background," *About Us* (2023).
[2] IsDB, "Previous Laureates," *Islamic Development Bank Prize* (2023).
[3] Tabung Haji, "Background" (2023).
[4] Tabung Hajj, *Annual Report 2021* (Lembaga Tabung Hajj, 2022), 23.
[5] Dubai Islamic Bank, "Our History," *About Us* (2023).
[6] Kuwait Finance House, "The History and the Beginning," *About Us* (2023).
[7] Jordan Islamic Bank, "Bank Establishment," *About Us* (2023).

wealth to save the bank instead of declaring bankruptcy. The chairman and the board of directors of the KFH suggested that shareholders bear all the loss instead of charging depositors their share of it to avoid a withdrawal run, which may lead to bankruptcy. Even the IsDB suffered a similar standby because governments in Muslim countries could hardly be able to develop good feasibility studies and offer trustworthy project structures that the IsDB could contribute to on the basis of mudarabah/musharakah.

### 2.2. Introduction of Murabahah to Islamic Banks

Upon this stagnation of the ability to provide Islamic commercial finance for both individuals and corporations by the newly established Islamic banks and the inability of the IsDB to offer any substantial financing activities to governments in its member countries, the new light came from a new Ph.D. dissertation by the late Sami Homoud. In this research, which came into publication in 1976, Homoud argued that Shari'ah-compliant financing may be provided through a combination of two sale contracts with a promise that links them together. The suggested way of financing came to be known as murabahah, although its full name is 'murabahah to the purchase orderer, who is also the promise-to-buy undertaker'. The contribution of Sami Homoud was really a kind of savior for Islamic banking. Murabahah allows the IB to offer financing to customers by way of buying goods that are bound by a promise to be, immediately upon taking delivery, sold and delivered to the customer. Since it has been practiced by the JIB, IsDB, DIB, and KFH, this new transaction took a tremendous amount of discussion among Shari'ah scholars and Islamic bankers over almost two decades until the mid-90s, when it was finally settled and almost unanimously accepted by Shari'ah point of view and dominantly practiced by all Islamic banks. The dominance of murabahah in the Islamic finance sector, especially in Islamic banks, does not mean that they do not use the other methodologies of Islamic finance, such as musharakah, mudarabah certificates, and musharakah mutanaqisah (MM). As noted by Ibrahim and Sapian [1], MM, which was involved in the Malaysian financial sector at the fourth and last stage of its development, can be considered an example of equity-based home financing. However, its share in the total value of home financing is limited to 18% in 2020. In addition, many researchers acknowledge that its practice may violate the nature of profit sharing, especially in the case of defaults, contract annulment, and ownership [2]. When we look at the liability side of the Islamic banks' balance sheet, it cannot be denied that mudarabah is still the best method of mobilizing funds in terms of efficiency and justice among stakeholders.

## 3. Risk-Sharing And Its Inadequacy

The first subsection shall briefly narrate the main points of the risk-sharing theorem and show why it claims that Islamic finance should focus on risk-sharing from a critical perspective. Then, we will proceed in the following three subsections to show the inadequacy of this proposition in its failure to distinguish between different kinds of risks and to identify the Shari'ah requirement in this regard, the fallacy that risk generates return and other deficiencies of risk-sharing theorem of Islamic finance.

[1] "Does Tawarruq Still Remain the Top Option for Islamic Home Financing (IHF) Products in Malaysia?," *Qualitative Research in Financial Markets* 15/1 (2023), 160–189.

[2] Ibrahim - Sapian, "Does Tawarruq Still Remain the Top Option for Islamic Home Financing (IHF) Products in Malaysia?," 171.

### 3.1. Fundaments of Risk-Sharing Theorem of Islamic Finance

3.1.1. Al-Mudarib Yudarib

The risk-sharing theorem of Islamic finance rests on the classical concept of al-mudarib yudarib in Islamic jurisprudence to enable the functioning of Islamic banks through mudarabah contracts in providing finance to clients. Al-mudarib yudarib means investing the fund acquired through a mudarabah contract in another mudarib by the first mudarib with a consecutive mudarabah contract. As described by Siddiqi [1], the fund mobilized by Islamic banks on the basis of mudarabah is permissible to be disbursed to those who seek financing on the same basis. The contemporary practice of the classical concept of al-mudarib yudarib is defined as two-tier mudarabah in the context of Islamic banking. The proponents of the risk-sharing theorem of Islamic finance rely on this permissibility of the two-tier mudarabah to promote the proposed and idealized way of risk-sharing finance.

The model of al-mudarib yudarib consists of three parties: fund owner, intermediary, and fund user. As elaborated by Siddiqi [2], the intermediaries, Islamic banks in this case, receive the fund from the fund owners on the basis of mudarabah and agree that they will use the fund to make a profit and that the profit will be shared in pre-determined proportions. Then, the fund users approach the intermediaries and sign another mudarabah contract to invest the fund in an industrial or commercial project/business and share the profits generated with the intermediaries. All parties are entitled to get a share in the profit. While the fund users' share in profit is deemed a result of their successful efforts in producing added wealth, fund owners' shares are justified based on the risk exposed and the amount of savings directed to the profit-generating activities. On the side of the intermediaries, their shares are considered for selecting the right fund users [3].

### 3.1.2. Justice and Throwing Risk

Risk-sharing is suggested to be the Quranic position on all economic relations and the ultimate objective of Islamic finance according to some Islamic economists, although the concept is neither explicitly mentioned in the Qur'an, Sunnah, and other Islamic sources nor developed by the Islamic economic and finance literature [4]. The starting point of the proponents of risk-sharing as the basis of Islamic finance is verse number 275 of the Surah al-Baqarah, which states that "Allah has permitted trading and forbidden interest" (وأَحَلَّ الله البيع وحرَّم الربا) (Qur'an: 2:275). Although most writers in Islamic economics and finance literature clearly acknowledge the prohibition of interest without any exception, the question of the alternative to interest-based financing leads to different perspectives among Islamic economists. In this regard, the proponents of the risk-sharing theorem argue that the alternative to interest-based financing is partnership or profit-and-loss sharing contracts, such as mudarabah and musharakah [5].

[1] "The Comparative Advantages of Islamic Banking and Finance" (Cambridge, Massachusetts: Center for Middle Eastern Studies, Harvard University, 2000), 186.

[2] "Islamic Banks: Concept, Precept and Prospects" (Saudi Arabia: Al Rajhi Banking and Investment Corporation, 1996).

[3] Siddiqi, "Islamic Banks: Concept, Precept and Prospects."

[4] Hossein Askari et al., *Risk Sharin in Finance: The Islamic Finance Alternative* (Singapore: John Wiley & Sons (Asia), 2012), 51–52; Said Bouheraouna, *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, ISRA Research Paper (Malaysia: International Shari'ah Research Academy for Islamic Finance, 2016), 6, 12.

[5] Khurshid Ahmad, "Islamic Finance And Banking: Challenge Of The 21st Century" (July 1998); Askari et al., *Risk Sharin in Finance: The Islamic Finance Alternative*, 50; Asutay, "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," 99; Abbas Mirakhor - Zubair Iqbal, *Islamic Banking* (Washington: International Monetary Fund, 1987), 3.

The permissibility of al-bay' (trading) and the prohibition of interest makes exchange and trade of assets as the foundation of economic activities, according to Askari et al. [1]. They note that trading enables parties to share production, transportation, and marketing risks and facilitates risk-sharing and diversification but do not elaborate on the link between trade and risk-sharing or diversification. In this regard, specialization and cooperation that are promoted by exchange among the parties who are specialized in various goods and services is offered by Bouheraoua et al.[2] to explain a possible connection between trade and risk-sharing, but this seems a far-fetched argument.

In addition to the arguments of Askari et al. [3], Bouheraoua et al. [4] approach the same issue, arguing that interest transfers risk through a debt contract from the lender to the borrower, and the alternative should then be risk sharing. They criticize the independence of the reward risk associated with lending activities. Further, they relate the reason for the prohibition of interest to the injustice stemming from the pre-determined return on the loan, regardless of the ex-post outcomes that will happen in the hands of the borrower. Through the considerations above, they argue the superiority of partnership or profit-and-loss sharing contracts in terms of justice, fairness, and other aspects [5].

**3.1.3. Development and Business Finance**

Development can be considered another vital concept for the risk-sharing theorem of Islamic finance. The backward socio-economic conditions of the Muslim-majority countries at the early stages of the contemporary Islamic economics and finance literature brought the need for development into the forefront. Thus, the idea of the development has overwhelmed the suggested theories. Even the Islamic moral economy (IME) has been positioned as a response to the underdevelopment of Muslim societies by aiming to establish a theoretical framework to tackle the social and economic backwardness of Muslim-majority countries, although the IME emerged in the 1970s [6].

The social, economic, moral, and political conditions of societies must be taken into consideration while producing policies and institutions. However, the impacts of the cyclical circumstances on the theoretical understanding—in this case, the theory of the basis of Islamic finance in particular and return in general—must be reduced. Otherwise, the theorem diverts from the facts and becomes dependent on temporary changes and circumstances. For instance, the IME supports partnership or profit-and-loss-sharing contracts in Islamic finance while discouraging credit and debt products, considering the need to develop Muslim societies [7]. In this regard, Asutay uses the phrases debt-based financing, debt-financing, credit, and debt products interchangeably. Interestingly, murabahah is also considered among them, which is positioned as the opposite of asset-based financing by Asutay [8].

The main argument behind the approach of the IME towards Islamic finance products is ensuring real economy-embedded financing for the development of Muslim societies through asset-based financing

[1] *Risk Sharin in Finance: The Islamic Finance Alternative*, 50.
[2] *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, 5.
[3] *Risk Sharin in Finance: The Islamic Finance Alternative*.
[4] *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, 12.
[5] Bouheraouna, *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, 9.
[6] Asutay, "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," 94–95.
[7] Asutay, "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," 99.
[8] "Conceptualising and Locating the Social Failure of Islamic Finance: Aspirations of Islamic Moral Economy vs the Realities of Islamic Finance," 102.

(Asutay, 2012, p. 99). Considering murabahah outside asset-based financing is a failure to distinguish creating a debt from starting with a debt. A loan contract begins with a debt. However, debt is a result of sales or lease contracts, not a starting point.
Another failure or fallacy in the context of the risk-sharing theorem of Islamic finance is the emphasis on the distinction between consumption and investment financing [1]. Financing consumption is assumed to be meaningless in terms of creating employment and real economic activities. However, consumption is a signal to the market, where the traders and producers manage their businesses and investment decisions accordingly. Increasing consumption through financing may lead to more investment and production to meet the increasing demand.
3.1.4. Promoting Entrepreneurship
The expected positive role of the partnerships or profit-and-loss-sharing contracts in promoting entrepreneurship is one of the main arguments suggested in the scope of the risk-sharing theorem of Islamic finance. Among the other factors, such as the institution of Zakah, the prohibition of the interest is considered a factor that enhances the environment for entrepreneurs in an Islamic economy [2]. The fact that entrepreneurs have to satisfy the conditions about creditworthiness, collateral, and reputation (social and political) and pay the principal and the interest even if they face a loss or low profit discourages entrepreneurial activities in the case of the interest-based finance system [3]. On the other hand, financing through partnership contracts, such as mudarabah and musharakah, is expected to encourage entrepreneurship by virtue of increasing the inclusiveness of the financial system and distributing entrepreneurial risks [4].

**3.2. Kinds of Risk in Islamic Finance**

Risk has multiple layers, kinds, and levels. Before arguing the risk-sharing proposition in detail, it is crucial to check the different kinds of risk because the risk-sharing theorem fails to recognize the essential differences between them. In this regard, we will elaborate on the market and ownership risks. Market risk has two components, which are price risk and liquidity risk. Price risk stands for the risk of selling a product at a price lower than its purchased or expected price. For someone who buys an asset at 10 Turkish lira (₺) intending to sell it for a higher price, the possibility of selling it at a lower price than expected or even its cost is the price risk this person assumes or bears. On the other hand, liquidity risk corresponds to the likelihood of the absence of a buyer for the product that you put up for sale. One of the most striking examples of the realization of liquidity risk is the 2007–2008 Financial Crisis. Although the stock market and the other financial markets went down 55% in one day, investors could not find buyers in the markets even at such low prices. The composite of the price and liquidity risks together makes the market risk.
One of the important aspects of market risk is being avoidable. In this context, we can exemplify how someone can avoid market risk through the most common way of financing by Islamic banks today. However, the case below is formed between two individuals without a banking institution. Let us assume someone who wants to buy a computer but does not have sufficient savings for a cash payment. He

[1] Bouheraouna, *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, 13.
[2] Eko Fajar Cahyono, "The Role of Financial Institutions and Social Security for Indonesian Household Opportunities to Opens Businesses," *Jurnal Ekonomi Dan Bisnis Islam* 6/2 (2020), 275.
[3] M. Fahim Khan, *Essays in Islamic Economics* (United Kingdom: The Islamic Foundation, 1995), 131.
[4] Bouheraouna, *Implementing the IFSA Investment Account: A Risk-Sharing Banking Model*, 14; Khan, *Essays in Islamic Economics*, 147.

negotiates the price with the computer retailer, and they agree on 30,000₺. Then he promises another person that he will buy the computer in exchange for 35,000₺, payable over ten months, should this person buy the computer from the retailer for 30,000₺. Based on the promise, the computer is purchased at the price of 30,000₺ from the retailer by the person who accepts the offer of his friend to buy it for 35,000₺ on credit. The difference between the cash price and the deferred price enables the generation of profit.

The case above clearly shows that it is possible to avoid the price and liquidity risk, i.e., all market risk. The person who buys in cash and sells on credit avoids price volatility and secures the buyers before any purchase. However, it is not true to say that all risks related to their trading activities are eliminated. They still bear another kind of risk. After they own and possess the property, they are the ones who will handle any damage to the property until it is transferred to someone else through a sale. Such a risk that comes with ownership is called ownership risk, and the owners cannot keep away from it, contrary to price and liquidity risks, unless they sell out the property and literally hand it over to the purchaser. Hence, the first conclusion about the types of risk is that ownership risk is not separable from the owned asset, while market risks are. Secondly, there may be cases where there is no market risk, but still ownership risk exists. Eventually, the risk is not one big thing. Instead, it is of multiple layers, kinds, and levels.

### 3.3. The Causality Fallacy Between Risk and Return

The second important point that needs to be discussed in the context of risk is the link between risk and return. Many people are inclined to think that more risk brings more return. This belief rests on the high earnings generated by some businesses involved in risky investments. However, on the other side of the coin, numerous businesses fail with their risky investments. By definition, higher risk is present in cases where the difference between the outcomes of the worst and best scenarios is remarkable. Thus, risky investments can either lead to huge losses or generate high returns.

Focusing only on successful businesses may result in a causality fallacy between risk and return. Such an approach leads to the argument that high risk is the cause of the higher return. As a matter of fact, an observation on a sample of only unsuccessful enterprises can be used to establish another wrong causality relation between risk and return, which is the reverse of the previous one. Therefore, a need for a more comprehensive look at the cases related to risk and return must be acknowledged, and the link between them should not be taken as causality.

Furthermore, return and liability are the two essential characteristics of ownership. Someone who owns a thing earns any return generated by this property and bears all risks associated with it. Concerning Islamic financial and business transactions and all rational economic practices, the emphasis on full and complete ownership is tested by assuring that owners are fully liable for any loss their property incurs. The Prophet ﷺ makes bearing liability the sign of fullness and completion of ownership in his Hadith: “Return is [associated with] risk-bearing (الخراج بالضمان)” (al-Tirmithi, hadith no. 1285). This Hadith definitely affirms that once ownership is complete so that the owner bears full liability for the owned property, then such an owner deserves all the return generated by the property. It is not a causality relationship because the nature of risk itself is not able to generate any revenue. The fact is that whatever the risk one may take in finance, if it is not related to actual real assets, no return can be generated or even expected.

### 3.4. Deficiencies of the Risk-Sharing Theorem of Islamic Finance

Being the basis of a theory or practice requires it to be fundamental, inclusive, logically consistent, and applicable. This subsection is dedicated to attempting to understand whether the risk-sharing theorem of Islamic finance can be considered the basis of Islamic finance from these perspectives. In this regard, the deficiencies and failures of the risk-sharing proposition that prevent it from being the basis of Islamic finance are elaborated in the following subsections.

#### 3.4.1. Incompatibility of Risk-sharing with Human Behavior

Risks and risk-taking are parts of life. They are present in every action of human beings, including marriage and walking on the street. People vary in terms of their attitude toward the risks they encounter. While some people like to take more risks, others choose to avoid them as much as possible. However, there is an apparent general inclination toward averting risk among people. People prefer to own an asset in full rather than having partners in its ownership because of the possible disputes arising from additional risks that stem from moral hazard and fraud on the part of partners. Therefore, the concept of risk-sharing as a basis of finance contradicts human nature in terms of human beings' perceptions and attitudes toward risk. The Qur'an refers to this human nature in more than one place. “He does give you a parable from your own [experience]: do ye have partners among those whom your right hands possess, to share as equals in the wealth We have bestowed on you? And to fear them as ye fear your own self” (Qur'an, 30:28). “God puts forth a Parable a man belonging to many partners at variance with each other, and a man belonging entirely to one master: are those two equal in comparison?” (Qur'an, 39:29). “David [eventually] ruled, ‘He has definitely wronged you in demanding [to add] your sheep to his. And certainly, many partners wrong each other, except those who believe and do good—but how few are they!’…” (Qur'an, 38:24). Obviously, the general human attitude is that a person prefers controlling their own property to having it controlled by others, unless there are good reasons to do so. Even when mixing properties is done, several additional procedures and processes are taken to ensure fairness and smooth management of properties. All such things are also costly.

#### 3.4.2. Risk, Finance, and Justice

One of the arguments of the risk-sharing theorem is that in Islamic finance, the fund provider must bear part of the risk of the transaction, as throwing all risks on the counterparty businesses violates the principle of justice, which is a fundamental pillar of Islamic finance, the Islamic economic system, and Islam itself as a religion. This argument is founded on a misconception of the risk-property relationship. Fairness and justice require that and are fully implemented when each owner bears their own risk. They are strongly violated when one party bears the risk of others, throws its own risk on others, and/or earns an increment not generated by its own property. Accordingly, justice is much more fulfilled through sale-based finance because, in the sale, each party controls their own property, deserves the return of owned property fully, and bears entirely the risk related to owned property, while in sharing contracts, one party controls the property of the other and may take disputed actions on it.

In the scope of the risk-sharing theorem of Islamic finance, partnership or profit-and-loss sharing contracts are proposed to be the alternative to interest-based financing, which results in throwing the risk to others and injustice. Nevertheless, fairness does not require risk sharing, and there is another alternative where every party makes their own decisions, bears their own risk, and is entitled to their own return, as in the case of sale contracts. A sale contract, not risk sharing, is, in fact, mentioned in the Qur'an (2:275) as an alternative of interest. While debt finance contracts place the whole risk of goods and services on the borrower, debt-creating sale-based and lease-based finance contracts place ownership risk on the finance provider by having its own before it can earn. Although profit-and-loss-sharing is one of the modes of finance covered by the property theory, its validity is not related to the amount of risk exposed or shared, contrary to what Khan [1] claims [2].

**3.4.3. Lack of Contribution of Risk-sharing to Value-Adding Production**

Finance providers carry out their businesses to earn profits. The financial instruments are designed to enable financial intermediaries to generate revenues. While it is not possible to have revenues without producing added value, the generation of the latter cannot be attributed to a conceptual and perceptual phenomenon such as risk. Accordingly, putting resources together in any form of risk-sharing is, itself, unable to produce added value. In the simple real-life process of putting resources together, we notice that the generation of added value occurs only when the products of a 'sharing project' are sold, not when the sharing entity is created. Sharing, when it is undertaken, is done to reach the optimal size of the productive entity. Of course, there are many economic benefits of functioning at the optimal size in terms of efficiency and productivity, but these are obtained at the cost of losing private control and increasing costs. Even when you put resources together to reach the optimum size of the firm, generating added value is only done at the point of making a sale, not at the point of sharing.

3.4.4. **Risk is not an Asset that can be Acquired, Sold, or Traded**

As a fact of life, risk cannot have value. It is not an asset to be sold or purchased; thus, risk cannot be a subject of ownership or trade. This fact is the essential principle for which Islamic finance objects to conventional insurance companies whose business consists of risky sales/purchases. We object to the traditional insurance structure as a trade of risks. We can only cooperate to avoid, mitigate, and/or compensate for it. The fact that risk is not accountable for added value brings us to the point that risk-sharing itself cannot result in value production and profit generation. In other words, risk or risk-sharing is not the fundamental cause that can be considered either a sufficient or necessary condition for added value. Thus, it is inappropriate to position risk-sharing as a basis of finance, especially Islamic finance, which aims to earn profits by facilitating productive activities.

3.4.5. **Unsuitability of Risk-sharing for Consumer Finance**

Fund disbursement instruments based on risk-sharing, such as mudarabah and musharakah, are well-known in the Islamic finance industry. These instruments are applicable for financing productive and commercial activities. However, unlike production and commerce, consumption does not have the objective of profit generation, concrete outcomes or value added that can be shared. Therefore, the question of what can be shared arises in the case of consumer finance if you want to base it on risk-sharing.

Education is one of the sectors in which people need consumer financing. In the case of financing the education expenditures of a client based on risk-sharing, the client aims for and is expected to generate some utilities in the forms of better employment, higher wages, more knowledge, an increased network, and so on. At this point, some impediments to sharing the gains achieved owing to the mudarabah contract occur. First, not all forms of utility attained by the client are directly sharable or convertible to an objective measure, such as money. Second, if only utilities can objectively be measured, such as those

[1] *Essays in Islamic Economics*, 12.

[2] Zubair Hasan, "Risk-Sharing: The Sole Basis of Islamic Finance? Time for a Serious Rethink," *Journal of King Abdulaziz University: Islamic Economics* 29/2 (2016), 23–36.

resulting in wage increases are taken into consideration, the question of what the contribution of the financing is in completing the education and being employed and what is attributable to other factors, such as the student's intelligence, prior learning, family support, attitude, hard work, etc. As a matter of fact, the wages of the graduates of the same faculty, even from the same university, may highly vary. Therefore, the financial instruments based on risk-sharing are not suitable for consumers' education finance, let alone other forms of consumer finance such as food, housing, home appliances, and marriage financing.

**3.4.6. Implications of Wakalah in Islamic Commercial Banks**

The Wakalah, on whose basis Islamic commercial banks receive investment deposits and whose basis shareholders authorize the IB's management to make decisions, requires Islamic commercial banks to minimize all kinds of risks that afford minimization and simultaneously avoid all avoidable risks. It is needed because this wakalah is, from the Shari'ah point of view, governed by the nature of the entity to which it is given, i.e., the nature of Islamic commercial banking. Unlike venture capital or investment banks, commercial banking is required to avoid and minimize risks. This practice is common among commercial banks based on the supervisory authority's instructions and creates trust in commercial banks to the extent that the public feels safe and comfortable depositing funds with them. These implicit conditions are considered as if they are literally written and part of the wakalah contract of investment deposits and management appointment and authorization.

When the alternative financing methods, namely partnership or profit-and-loss-sharing contracts, are considered from the perspective of the wakalah mechanism in Islamic commercial banks, their deficits become prominent. For instance, mudarabah is susceptible to moral hazard risks on the part of capital users, since all losses are borne by the capital provider. There is also an information asymmetry in favor of the capital users because the capital provider is not involved in managing the partnership in the case of mudarabah. As noted by Khan [1], these deficits may cause limited investments in a single mudarib, lower mudarabah investment in total, and thus a decline in the profitability of banks unless there is a well-functioning secondary market of mudarabah certificates. Musharakah partially solves the problems of moral hazard on the part of banks' clients and informational asymmetry based on the fact that the banks have the authority to be involved in the management of the partnership, and the clients also invest capital in the projects [2]. Nonetheless, it is hard to follow and manage each project where the banks become partners through musharakah contracts on the part of the banks [3]. These considerations bring us to the point that partnership or profit-and-loss-sharing contracts may be incompatible with the business structure of banks and cannot realize the expected results.

**3.4.7. Lack of Predictability of Yields of Finance Based on Risk-sharing**

The risk-sharing contracts, mudarabah and musharakah, provide neither a pre-determined profit nor a maturity date because of the nature of their respective structures. Although the ratios for the distribution of profits are known beforehand, there is still a great deal of uncertainty about the contracting parties' actual returns and their percentage relationship to invested capital since the total profit depends on the performance of the management, economic conditions, and many other factors. There is also always a

[1] *Essays in Islamic Economics*, 103.

[2] Shahari Farihana - Md. Saifur Rahman, "Can Profit and Loss Sharing (PLS) Financing Instruments Reduce the Credit Risk of Islamic Banks?," *Empirical Economics* 61 (2021), 1104.

[3] Khan, *Essays in Islamic Economics*, 103–104.

possibility of losses, which will be distributed proportionately to the partners' capital contributions. Since predictability is vital for the financial intermediation industry to manage liquidity, the deposit holders' and shareholders' earnings, and expectations of generating foreseeable profits, the fund disbursement methods based on risk-sharing are one of the least suitable for the business of financial intermediation in general. It is more unsuitable for Islamic financial intermediation because of the binding requirements of wakalah, which include full transparency, honesty, and faithfully acting in the best interests of shareholders and investment depositors. This feature is one of the reasons why these risk-sharing modes of finance are the least applied methods in Islamic banks. A financing method that is hardly applicable cannot be positioned as the basis of Islamic finance.

#### 3.4.8. **High Cost of Risk-sharing for Islamic Banks**

The Islamic Finance Services Board (IFSB) makes standards that help supervise Islamic banks. One of the essential standards published by the IFSB is the Capital Adequacy Standard for Institutions Offering Islamic Financial Services (IIFS) [Banking Segment]. This standard mainly sets the rules and principles regarding the capital adequacy requirement (CAR). It provides applicable capital charges for each Islamic financing contract and investment asset. When the capital requirements listed for various stages of the murabahah contract are considered, it is observed that credit risk weight (RW) is not applicable for most stages of murabahah contracts, whether there is a binding or non-binding promise in the murabahah for the purchase orderer. For some stages, such as when an asset is sold and delivered to a customer, the credit risk weight is determined based on the customer's rating or 100% RW for unrated customers [1].

On the other hand, capital requirements for mudarabah and musharakah contracts go up to 400% RW depending on sharing contract categories and applicable stages of the contracts [2]. These comparative requirements show that fund disbursements based on risk-sharing contracts cause additional costs in the form of capital requirements for Islamic banks. Such an additional cost is expected because sharing contracts brings more risks stemming from the morality of other partners involved in the contracts. In other words, the IFSB increased the capital requirement for sharing contracts because their nature makes them riskier and, thus, more costly for an Islamic intermediary financial provider.

## 4. A Property (Asset) Ownership Theory Of Islamic Finance

### 4.1. Origins of the Financing Methods of Islamic Banks

Today's Islamic banks provide financing to businesses, consumers, and governments based on one of the three broad modes of sale, lease, and sharing, all of which are derived from Shari'ah. When we look closely at these three principles or fundaments of Islamic finance and see what that means when we only give financing on different forms of sale, leasing, or sharing with or without participation in management, we notice that all their modes and contracts also exist in the commercial laws in all countries. These contracts were not invented by the Prophet Muhammad ﷺ. Before the Prophet Muhammad ﷺ, there were sales on credit, sales with advanced payment and deferred delivery, leasing, and sharing relationships where people came together and created partnerships. To take it one step further, we can also say that

[1] IFSB, *Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Banking Segment]*, IFSB Standards (Malaysia: Islamic Financial Services Board, December 2021), 152–153.

[2] IFSB, *Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services [Banking Segment]*, 179–185.

these contracts and ways of financing are known in all societies, Muslim and non-Muslim alike. They exist and existed through time in the long past, early times, before Islam.
In fact, what the Shari'ah did is as expressed exactly by a Hadith of the Prophet Muhammad ﷺ, when he said: "I was sent exclusively to complete good ethical morals (إنما بُعِثتُ لأتمم مكارم الأخلاق)." That is to refine, complete, and remove any vagueness, ambiguity, or room for dispute in these contracts. An example of such refinements in the Sunnah is the Hadith, "Whoever contracts a salam contract, he should do it on a definite quantity [in volume or in weight] for a definite maturity ( من أسلف فليسلف في كيل معلوم و وزن معلوم إلى أجل معلوم)."[11] Salam contract was done before the Prophet ﷺ. It was only refined but not invented by the Shari'ah.
Islamic finance actually took these contracts from commercial laws (Fiqh al Mu'amalat) and made them the core of financial intermediation and banking so that Islamic banks could do their business based on these contracts and completely avoid loans. Funds may be mobilized in Islamic banking through either sharing or loans with no return and can be disbursed only through sale, lease, or sharing relationships. This change, simple and small as it may look, placed the financial transaction as a part of the production process, the process of creating added value.

**4.2. A Property Theory of Islamic Finance**

Today's Islamic banks use three general methodologies or ways in their finance provision activities: sale, lease, and sharing. As noted before, these methodologies and all the contracts within them are well-known in commercial laws. The only addition or change made by Islamic banks is to take these three methodologies and their contracts as the only ways of financing in Islamic banks. By doing so, they exclude the loan contract and throw it out of their normal profit-aiming banking practices.
To understand the foundation of these two actions of bringing in sales, leasing, and sharing and taking out loans, we need to look closely at these relationships and the implications of the detailed contracts. Sale contracts, in all their formulations, transfer ownership of assets, goods, and services from suppliers to purchasers. They also transfer ownership of the price in the opposite direction for the objective of financing either or both sold items, and the price may be forward or deferred. When IB finances on sale contracts, murabahah, salam, istisna', etc., sold items must pass into the real and complete ownership of the bank. Without this condition, earning is not deserved, i.e., the IB can take no return (profit).
The lease contracts in all their varieties also require the IBs to own a long-living asset and be able to sell its usufruct. In this regard, the IBs must not only own assets but also continue owning them (along with keeping the usufruct available to the lessee) until the end of the lease period. As for sharing contracts, i.e., mudarabah, musharakah, and even muzara'ah, require the IB to own and remain the owner of partnership shares in value-adding and profit-generating business projects until the maturity and sale of their products. These considerations also show that the property-based theory is realistic and contains, under its folds, the risk-sharing contracts and modes of financing.
In other words, Shari'ah-compliant financing must always pass through ownership, and the Islamic bank must own utility-producing and added-value-generating real properties before giving them to its clients on financing. An immediate implication is that the IB becomes a part of the supply chain of the production process, which is in contrast to interest-based financing that keeps the finance provider outside the process of value-adding production.
To complete the picture, we need to look at the contract which IBs exclude from the financial arena. Although the loan contract, like a sale, transfers the ownership of loaned money to the borrower and

creates a real asset, debt on the recipient, Islamic banks take it out of the domain of financing. The critical difference is that in the sale contract, we give a property that, by itself, creates added value. On the other hand, in the loan contract, the lender has a mute asset, debt, which is not able to generate any utility or added value. This issue has been elaborated on through the concept of the time value of real goods in the following subsection.

Consequently, Islamic finance is property-based. By being property-based, it integrates financing into the production process and makes its earnings derived from the added value or wealth generated anew. This feature gives the earnings in Islamic finance a moral and rational base, lacking in interest-based finance.

**4.3. Time Value of Real Goods**

Murabahah, as the most common fund utilization method in Islamic banking, is based on the sale on credit, enabling the buyers to pay the price of the assets in the future as one payment or in installments rather than paying cash. The difference between the spot and deferred prices allows banks to profit. The legitimacy of this price difference in Shari'ah is described with a well-known Fiqh maxim, asserting that "part of the price belongs to time (من الثمن إن للزمن نصيبا)."[12] This maxim implies that the deferment of payment of the counterpart of a commodity may deserve an increase in its price, as maturity is one of the elements in commodity price determination. Payment deferment generates a portion of the price, as stated by Al Nawawi.[13] So, the price is partially attributable to time, or it increases or decreases because of time of payment.

The same principle is present for another form of sale contract, salam. In the salam contract, payment is made in advance while delivery of the sold goods/assets is deferred. Salam can be considered the opposite of a murabahah contract to some extent in terms of the timing of payment and delivery. Thanks to its structure, the salam contract has been widely used to finance producers, especially farmers, for a long time. The buyers take advantage of lower prices compared to spot prices during the season and reduce the uncertainties regarding the supply of agricultural products. Again, the same principle that 'part of the price is caused by the time' can be clearly seen in the context of a salam contract. As a matter of fact, the longer the maturity of the salam contract, the lower the price would be.

At this point, one may argue that the price difference in murabahah and salam contracts, depending on the maturity of payment and delivery, resembles the time value of money and justifies interest. However, there are structural differences that distinguish the two. First, the above principle is about thaman, which means the price of a commodity and implies a commodity is changing hands. So, the delivery time of the commodity implies utility/value obtained or forgotten. Accordingly, this maxim does not stand for the price of debt (interest) because debt does not have utility. Second, the 'time value of money' is actually derived from the 'time value of real goods', which is another expression of 'consumption today is preferred over consumption tomorrow.' It does not hold when there is no utility variation depending on time. For instance, when someone is asked to receive money provided that he/she must not transform it into any asset until a particular time, he will be indifferent between taking the money now or at the end of the deadline when he is able to utilize it. However, when the subject of the conditional transfer becomes a real good, the decision will be taken in favor of acquiring the property now. In other words, having a utility-generating real good in advance or later matters because real goods have utilities they create, while money itself does not generate such utility.

## Conclusion

Contemporary Islamic finance literature, especially in Arabic, has several writings on the Mit Ghamr experiment, including those by the late professor Ahmed Al-Najjar himself. Since the Mit Ghamr functioned on the basis of mudarabah on both sides of the transaction, the idea of risk-sharing has become dominant in the literature, and the mark-up mechanism was neglected. According to many writers, the main principle of Islamic banking must be risk-sharing, and the literature is still chanting the concept of risk-sharing as the basis of Islamic finance today.

The concept of risk-sharing as the core of Islamic finance, i.e., financing through mudarabah or musharakah, was common among scholars and practitioners when the early commercial Islamic banks started to be established in the 1970s. However, the risk-sharing concept did not work with Islamic commercial banks mainly because mudarabah and musharakah could not be appropriate options for Islamic banks' risk management considerations, which are binding requirements of wakalah toward shareholders and investment depositors. Sale-based finance, especially the murabahah proposed by the late Sami Homoud and ijarah ending with ownership transfer, became the savior of Islamic banking and finance.

This paper argues that the three general financing methods of sale, lease, and sharing exclusively require Shari'ah-compliant financing to always pass through ownership, and the Islamic bank must own utility-producing and added-value-generating real properties before giving them to its clients on financing. In addition, the distinction between Shari'ah-compliant financing methods and interest-based financing has been asserted through the concept of the time value of real goods. Thus, it is argued that ownership of increment-generating assets/goods is the justifier of return in finance. Consequently, as property-based, Islamic finance integrates financing into the production process. This feature makes its earnings derived from the created added value and gives the earnings in Islamic finance a moral and rational base, lacking in interest-based finance. Conversely, this paper rejects the claim that puts risk-sharing as a basic foundation of Islamic finance and its distinguisher from interest-based finance, considering both the experiences of early Islamic banks and the fundamental deficiencies of the risk-sharing theorem.

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