

## Risk sharing and risk shifting: An historical perspective<sup>☆</sup>

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### Abstract

Islam prohibits risk shifting and encourages risk sharing. Consequently, Muslims have developed over the centuries a highly sophisticated know-how of risk sharing partnerships which was the envy of the world. When Europe borrowed this know-how from the 10th century onwards, it entered into the era of “commercial revolution”. 13th century Venice, 19th century Germany and the 20th century United States are the three western cases presented in this article, which demonstrate the dramatic achievements of risk sharing in the West. Thus, the wisdom of the Islamic prohibition is confirmed by these Western examples. The paper then examines how Muslims can re-introduce risk sharing techniques into the modern Islamic finance.

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Classical sources of Islam prohibit interest transactions but encourage business partnerships and trade. While interest transactions shift risks from the capitalist to the entrepreneur, partnerships lead the two to share them. Thus, it follows that Islam prefers risk sharing to risk shifting.<sup>1</sup>

Since it is the risks which generate profits and losses, it follows that when risks are shared, profits and losses are also shared. Therefore, risk sharing leads to a share economy, that's what an Islamic economy is supposed to be all about.

But all of this is theory. What about application? In all cultures economic theory is translated into application via institutions. If so, which institutions are we talking about? We

start with the interest prohibition and business partnerships. Everything boils down to how the capital of the capitalist is combined with the work and talent of the entrepreneur. In the conventional system this is done with credit transactions and the rate of interest. In an Islamic economy it is done by business partnerships.

Two questions come to mind here:

- 1) Which partnerships ?
- 2) Are these partnerships specific to a locality or are they universal?

In Islamic economic history, the most important partnerships observed were the *mudaraba* and its derivatives. *Mudaraba* was born in the Middle East and then spread to the whole of the Islamic world from the Atlantic to the Pacific.

With the crusaders, it even spread to Europe. During the late 12th century Eleanor of Aquitaine, the Queen of France, brought the Islamic law of Partnerships, as well as the Admiralty Law, from Jerusalem to France. In France, at the Island of Oleron, these laws were then incorporated into the

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<sup>1</sup> For substantial evidence on this see; Abbas Mirakhor and et.al, *Risk Sharing in Finance, the Islamic Finance Alternative* (Singapore: John Wiley and Sons, 2012), pp. 52–53.

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Lex Mercatoria – the medieval European law of commerce.<sup>2</sup> During this incorporation, Islamic *mudaraba* was called *commenda* by the Europeans.

Borrowing the Islamic risk sharing partnerships appears to have had a huge impact on European economic, financial and even political history. To start with, soon after the incorporation, Europe entered into a period of massive increase in commerce, known as the “commercial revolution”. Put differently, it was the risk sharing *mudaraba/commenda* contract which financed this massive increase of trade both within Europe and across the Mediterranean.

Two Italian city-states Genoa and Venice specialized in trade between Europe and the Islamic world. Acemoğlu and Robinson have demonstrated definitively that Venice became a super power of the period thanks to its new merchant class using the *mudaraba/commenda*. But when the old elite began to fear the rising new merchant class and decided to prohibit *mudaraba/commenda*, during the late 13th century, this was the beginning of decline for Venice.<sup>3</sup> Indeed, for as long as the young men of Venice could freely practice the *mudaraba/commenda* in foreign trade, Venice prospered and became powerful. But when this risk sharing contract was banned and the rising new mercantile class was ousted from the decision making process, the city began to decline.

To this 13th century Venetian example we can also add the late 19th century example from Germany. Recently, the well-known Gerschenkron hypothesis stating that the “peculiar character of Germany's financial institutions played a critical role in industrialization and in overtaking of England” has been confirmed.<sup>4</sup> The “peculiar character” refers to the fact that stock markets in Germany replaced loan markets as the major source of capital.<sup>5</sup> In the terminology of this paper, this means that risk sharing had replaced risk shifting as the most important method of finance in Germany and, according to Gerschenkron as confirmed by Lehmann, this replacement played a critical role in the industrialization of Germany and its success in overtaking England, where loan markets continued to predominate.

These two European cases, one from the 13th and the other from the late 19th centuries, demonstrate without any doubt whatsoever the power of risk-sharing finance. In what follows, I will refer to a third case as well, the American venture capital of the late 20th century, which will also confirm the basic

argument here. But before doing so, we need to go back to the Islamic world and study risk sharing in Islam further.

## 1. Resilience of Islamic partnerships

Another remarkable feature of the classical Islamic partnerships is their resilience. A thousand years after their birth, they can be observed in Ottoman finances without any change in their structure.<sup>6</sup>

There is one financial instrument, however, which can be considered as typical Ottoman. These were the Cash Waqfs. Cash waqfs were charitable foundations established with cash.<sup>7</sup> In brief, their *modus operandi* was as follows:

A wealthy person donated a certain amount of cash for a charitable purpose. The money was invested and the revenue it generated was spent for the charitable purpose of the donation. When Imam Zufar was asked during the 8th century how a cash waqf should function, he said, the cash capital should be invested with *mudaraba*.

But when Ottoman cash waqfs were studied, it became clear that they did not apply *mudaraba*. Had they done so, they would have become risk sharing instruments. Instead, they applied *istiglal*, a basically risk shifting instrument.

We wonder at this point why the Ottoman cash waqfs failed to apply Imam Zufar's ruling and in the process became risk shifting institutions. The most plausible explanation is the profit limits imposed by the Ottoman state. As it is well known, *mudaraba* is a risky instrument and it may end up with losses. Such losses can be tolerated only if there is no upper limit imposed on profits so as to compensate the losses with the high profits generated. But maximum profit limits in the range of 5–20 percent was the rule in the Ottoman economy. With such profit controls waqf trustees refused to apply the risky *mudaraba* and preferred *istiglal*. Thus, profit limits imposed by the state killed any potential for risk sharing by cash waqfs. So, the relevance of all this for us today is that risk sharing and profit limits imposed by an authority are simply incompatible.

All of this pertains to private finance. What about state finance? Indeed, all governments need to borrow money from the public. But how does an Islamic government do this? Obviously it cannot borrow with interest.

The earliest solution found was tax-farming. The origins of tax-farming can be traced back to the early centuries of Islam. The Ottoman version of this system was called *iltizam*. In *iltizam* taxes were collected by the private enterprise and entrepreneurs were delegated the right to collect taxes. So, can we consider this arrangement as risk sharing? Not really, the state was shifting all the risks upon the agent or the entrepreneur. Indeed, the entrepreneur not only paid a fixed amount

<sup>2</sup> Daniel Panzac, “Le Contrat d’Affrement maritime en Méditerranée”, *Journal of the Economic and Social History of the Orient*, vol. 45, No. 3, pp. 351–8; Alison Weir, *Eleanor of Aquitaine*, p.1, 318; Hassan S. Khalilieh, *Admiralty and Maritime Laws in the Mediterranean*, (Leiden: E. J. Brill, 2006).

<sup>3</sup> Daron Acemoglu and James A. Robinson, *Why Nations Fail*, (New York: Crown Business, 2012), pp. 152–156.

<sup>4</sup> Sibylle H. Lehmann, “Taking Firms to the Stock Market: IPOs and the Importance of Large Banks in Imperial Germany, 1896–1913”, *Economic History Review*, Vol. 67, No. 1, 2014, 92–122.

<sup>5</sup> Sibylle H. Lehmann, “Taking Firms to the Stock Market: IPOs and the Importance of Large Banks in Imperial Germany, 1896–1913”, *Economic History Review*, Vol. 67, No. 1, 2014, p. 93.

<sup>6</sup> Murat Çizakça, *Comparative Evolution of Business Partnerships* (Leiden: E. J. Brill, 1996).

<sup>7</sup> Murat Çizakça, *A History of Philanthropic Foundations: Islamic World from the Seventh Century to the Present* (Istanbul: Bogazici University Press, 2000). Also available at [www.muratcizacka.com](http://www.muratcizacka.com) and [www.academia.edu](http://www.academia.edu).

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