

## Equality through Profit and Loss Sharing in Islamic Economics

The purpose of this article is to present and analyze the understanding of a specific rule of equality in the Islamic economy. There are significant cultural differences between the Western culture and the culture of Islam with regards to this principle.

### THE BASICS

The name “Islam” comes from the Arabic word “asalama” which means “surrender, submission” to the will of Allah. Allah is at the heart of religion, is considered to be the creator of law and morality, and he will finally “weigh” the deeds of Muslims after they die. The beginning of Islam dates back to the years 610–632 AD when Muhammad had experienced a series of visions in which God had disclosed to him the content of the Holy Book of Islam, namely the Quran<sup>1</sup>.

Islam is the basis for philosophy of life for the fifth part the world’s population<sup>2</sup>.

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<sup>1</sup> More on the history and origins of Islam in: e.g. J. Bielawski, *Religia państwa i prawa*, Warsaw 1973; Ł.R. Sjukijajnen (ed.), *Prawo muzułmańskie*, Warsaw 1990; I. Edge, *Islamic Law and Legal Theory*, New York University Press, New York 1992; A. Bartnicki (ed.), *Zarys dziejów Afryki i Azji 1869–1996. Historia konfliktów*, KiW, Warsaw 1996; J. Danecki, *Arabowie*, Państwowy Instytut Wydawniczy, Warsaw 2001; J. Danecki, *Kultura islamu. Słownik*, WSIP, Warsaw 1997; J. Danecki, *Początki reformizmu muzułmańskiego. Dżamal ad-Din al-Afgani i Muhammad Abduh*, Euhemer 3–4, Warsaw 1987; J. Danecki, *Polityczne funkcje islamu*, Wydawnictwo UW, Warsaw 1991; M.M. Dziekan, *Historia Iraku*, Dialog, Warsaw 2002; P. Hitti, *Dzieje Arabów*, transl. W. Dembski, M. Skuratowicz, E. Szymański, PWN, Warsaw 1969; A. Hourani, *Historia Arabów*, Marabut, Gdańsk 2002.

<sup>2</sup> The geographical region covered by the Muslim culture at the beginning of the 21st century is enormous. In several dozen of countries Muslims are majority. These countries among others include: Egypt, Jordan, Liban, Palestine, Turkey, Uzbekistan, Bangladesh, Indonesia Malaysia, Senegal, Saudi Arabia, Iran, Kuwait, Mali, Morocco, Mauritania, Oman, Pakistan, Sudan, Syria, United Arab Emirates, Bahrain. There is a significant Muslim population in Ghana (14%), Ivory Coast (14%), Nigeria (35%), Tanzania (36%) and Uganda. See P. Kubicki, *Spoleczeństwa Islamu, system wartości oraz stosunek wobec Zachodu*, *Spoleczeństwo – Polityka – Tradycje* 2004, No. 1, p. 98. Mosaic of regimes of Muslim countries is also very rich - from Turkey, aspiring to the European Union membership, through semidemocratic Morocco, to the fundamentalist Saudi Arabia. See: for example: F. Ajami, *Szejkwowie, myśliciele, terroryści*, transl. M. Dziekan, *Fakty*, Warsaw 2002; G. Corm, *Bliski Wschód w ogniu. Oblicza konfliktu 1956–2003*, transl. E. Cywiak, R. Strykowski, *Dialog*, Warsaw 2003; B. Tibi, *Fundamentalizm religijny*, transl. J. Danecki, Państwowy Instytut Wydawniczy, Warsaw 2001; B. Tibi, *Islam i polityka. Islam polityczny oraz fundamentalizm muzułmański*, *Bliski Wschód. Spoleczeństwo – Polityka – Tradycje* 2004, No. 1; A. Waskiewicz, *Czym jest fundamentalizm*, *Spoleczeństwo Otwarte*, No. 6,





For Muslims the Qur'an is not only a Holy Book, but the source of all ethical and legal standards. It consists of 114 Suras and 6226 Verses. The second source of norms in Islam is the Sunnah, or the record of the proceedings of Prophet Muhammad. Quran and Sunnah together constitute the sacred law of Islam, namely Sharia. The third element building the Islamic law is the legal doctrine: *fiqh*, or the study of Islamic law, as well as *ijtihad*, or interpretation of the law, primarily using *qiyas* (reasoning by analogy)<sup>3</sup>.

Islam is one of the key cultural factors connecting selected markets in the Far East (eg. Indonesia) and the Middle East (e.g. United Arab Emirates). Relationship with the economy is inseparable from religion in those parts of the world.

At the same time for more than 20 years one may notice a significant growth and increasing dynamics of economic cooperation between the countries from the Western culture and the culture of Islam. A good indicator, which illustrates the commitment of the institutions of Muslim countries in the international markets is an indexed consolidated financial exposure of banks of those countries in Europe.

The involvement of banks from Muslim countries started to grow steadily in the early eighties, however in the last five years it has already recorded 20–50% increases year on year. In 2008, based on data from the Bank for International Settlements (BIS), the exposure was more than fifteen times higher than in the early 80s of the twentieth century (Figure 1).

Institutions from Muslim countries have engaged themselves since the 80s of the twentieth century in a number of significant investments. They have been buying and selling shares in large corporations, they have also taken over control of large multinationals<sup>4</sup>.

This dynamic development of Islamic capital groups' investments in the Western markets would not be possible without the legislative support coming from these markets. From the middle of this decade countries both of Western Europe and Far East increasingly seek to actively promote the development of Islamic finance<sup>5</sup>. Numerous initiatives range from the

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Warsaw 1994; G. Kepel, *Święta wojna. Ekspansja i upadek fundamentalizmu muzułmańskiego*, transl. K. Pachniak, Warsaw 2003; B.R. Zagórski, *Czy powinniśmy bać się Islamu?*, *Jednota* 2000, No. 8–9, available at: <http://www.jednota.pl/content/view/401/63/> (10 January 2009).

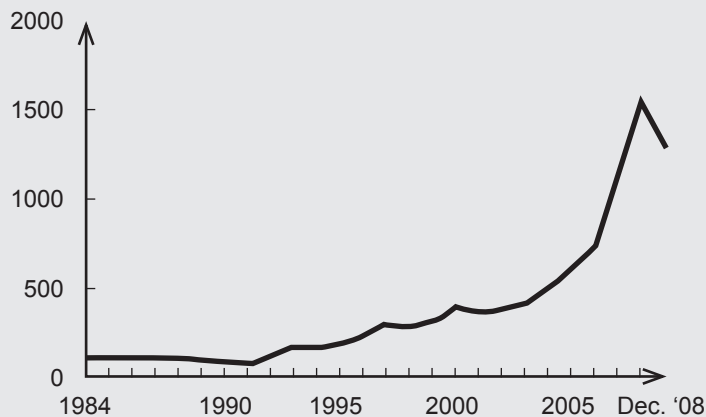
<sup>3</sup> On increasing interest in Islamic financial sector refer to L. Goffe, *US Islamic finance initiatives take off*, *Middle East*, October 2001, No. 316.

<sup>4</sup> Investors from Muslim countries own or owned shares of significant value in e.g. Citigroup, Time Warner, Apple, Tiffany&Co, PepsiCo, Motorola, Leica, Asto Martin, Porsche, Sony Corporation etc.

<sup>5</sup> Knowledge and understanding of the principles of the Islamic financial market opens an opportunity window to establish closer economic relations with businesses and customers from the Middle and Far East. Opening up for new markets through the activation of financial flows between them could become



FIGURE 1. INDEXED CONSOLIDATED EXPOSURE OF BANKS FROM MUSLIM COUNTRIES\* IN EUROPE (1984=100)



\* Muslim countries defined for this analysis as: Bahrain, Kuwait, Saudi Arabia, United Arab Emirates, Indonesia, Malaysia, Qatar  
Source: own analysis based on Bank for International Settlements (BIS) ([www.bis.org](http://www.bis.org)) data

promotion of sukuk issuance in Germany, modification of the tax law (so as to ensure fiscal neutrality of Islamic instruments) in the UK, preparation of law legalizing the Islamic financial instruments in Japan, to attempts to create and promote a liquid Islamic financial market in Hong Kong<sup>6</sup> (Figure 2).

Islam lays down a basis for cooperation between businesses by posing certain restrictions intended to safeguard the morality and ethics of business and fairness of contracts concluded between partners. "It is difficult for a modern, secular West to understand the culture in which no nationality, no citizenship, no origin, but religion, or more specifically membership in the religious community is a key determinant of identity, the object of loyalty and source of legitimacy" – notes prominent orientalist Bernard Lewis. Basic principles of Islamic law and economics are homogeneous, static and universal irrespective of the region of the world – that is the essence of Islam.

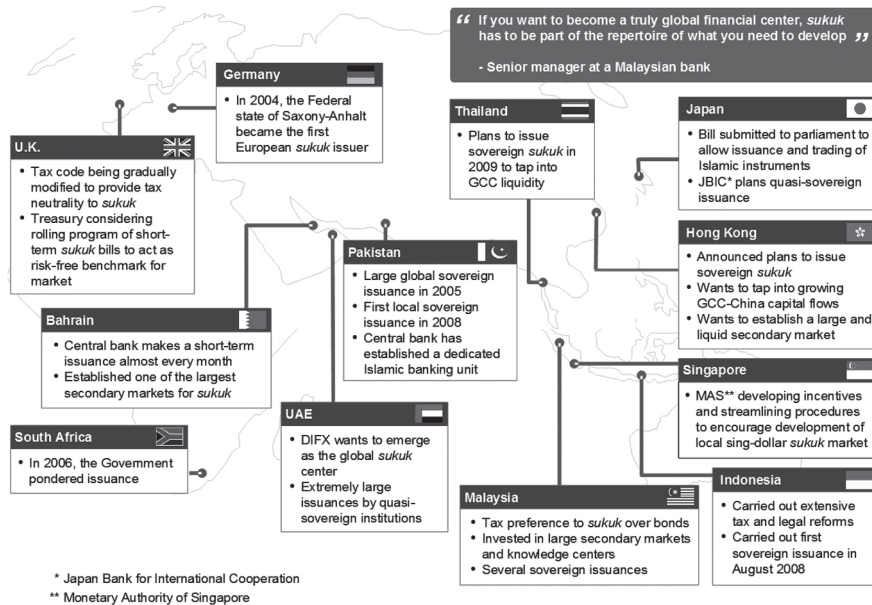
These principles include the protection of property rights, the obligation to work, the transparency in the relationships between contractors, profit and risk sharing, the prohibition of charging and collecting interest and the

an important factor stimulating economic growth. See: W. Siwiński, *Unia Europejska i wzrost gospodarczy – perspektywy dla Polski i krajów Europy Centralnej*, in: J.J. Michalek (ed.), W. Siwiński, M.W. Socha, *Polska w Unii Europejskiej. Dynamika konwergencji ekonomicznej*, WN PWN, Warsaw 2007.

<sup>6</sup> See: *McKinsey Islamic Banking Competitiveness Report 2006*, World Islamic Banking Conference in Bahrain, 2008.



FIGURE 2. SELECTED GOVERNMENTAL INITIATIVES SUPPORTING ISLAMIC FINANCIAL MARKET DEVELOPMENT (SUKUK EXAMPLE)



Source: Islamic Banking Competitiveness Report 2008, McKinsey.

prohibition to profit from competitive advantage build upon a disadvantageous relationship resulting from the lack of information about the transaction details or market situation.

### THE CONCEPT OF EQUALITY

In the Western economy the equality in business activity is understood as an equality in market access, equality in terms of burden posed on businesses, equality in terms of responsibility, and equality in the judicial protection. Exceptions are rare and be have to be regulated by laws.

In an Islamic economy equality is understood differently than in the Western culture. On of the key differences is the understanding of the profit and loss sharing principle. It is has important implications for all Islamic transactions, for example for the *murabaha* contract but also for the insurance (*takaful*). This principle is also a way of equalizing opportunities through donations (*waqf* and *zakat* etc.).



Quran assumes the existence of competition among market participants. Points out, however, two forms of competition: the “good” and “bad”.

“Good” competition leads to improvement of being of not only individuals but society (umma) as a whole. Is it Sura 5 verse 2 of the Koran: “Assist and support each other in matters of virtue and piety”<sup>7</sup>.

“Bad” competition leads to an improvement of the situation of an individual at the expense of other members of the community. Quran states it, among other verses, in Sura 5 verse 2: “Do not help each other in sin and transgression!”.

The aim of Muslims is to build the cooperation and compete with others but at the same time maintain principles of trust and transparency of cooperation. It is unacceptable that one party of the contract is not adequately informed about the terms of the agreement, and especially that he does not understand and does not know other facts that can have an impact on the contract and its value. Therefore, it is unacceptable to profit from the asymmetry of information when building transactions. It becomes apparent that for the Islamic economy it is an essential condition to develop more effective methods of exploitation of natural resources to produce goods and services and win the competitive game with other players. Competition is only supposed to stimulate a “healthy” development of new production techniques<sup>8</sup>.

Competition in the market should not lead to the weakening of solidarity and community cohesion, but only improve the utilization of available resources and push to ever greater wealth production, to improve the material status of the whole community (umma).

Thus, the main principle, clearly different from Western economics, is the participation of each party in the risk of the transaction emphasizing the importance of equality in building business relationships.

The existence of a profit without incurring the risk is unacceptable. An entity, willing to earn a profit and to achieve that by organizing a transaction, must bear in mind that the transaction is permissible under the rules of Islamic economics only, provided that both parties to the transaction are subject to risks of loss. Hence, transactions with a predetermined gain for one party are unacceptable<sup>9</sup>.

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<sup>7</sup> Quran 5:2, translation by dr. Munir Munshey, available at: [http://www.answering-christianity.com/quran\\_search.htm](http://www.answering-christianity.com/quran_search.htm), August 31, 2009.

<sup>8</sup> Z. Iqbal, A. Mirakhor, *An Introduction to Islamic Finance, Theory and Practice*, John Wiley & Sons (Asia), Singapore 2007, p. 43.

<sup>9</sup> See: I. Warde, *Islamic Finance in the Global Economy*, Edinburgh University Press, Edinburgh 2001; Z. Haque, *Riba. The Moral Economy of Usury, Interest and Profit*, Ikrq, Kuala Lumpur 1995.

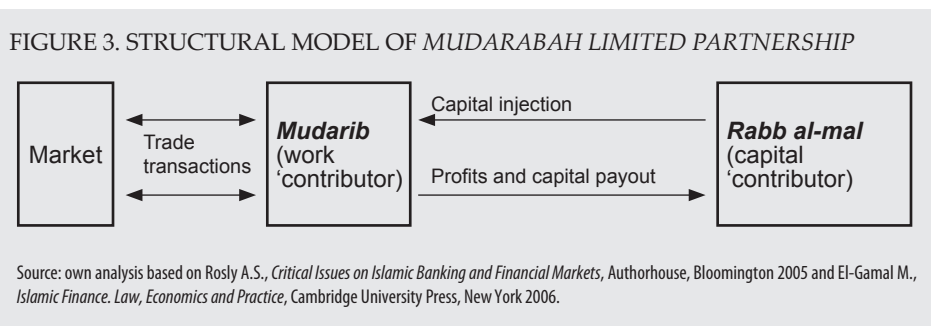
Secondly, there must be an element of risk. No one may claim the profit or fee for any transaction, if he has not been exposed to any risk. To make profits one needs to accept risks, because the return can only be a bonus for the exposure to risk – if there is no risk, then there is no profit<sup>10</sup>.

Most of the instruments available on the traditional Western financial markets do not satisfy at least one condition. For example, an interest-bearing savings account with a fixed interest rate involves some insignificant risk of bank’s bankruptcy. However this is negligible and the likelihood of the bankruptcy materializing is close to zero.

### SETTING UP BUSINESSES

In the purest form of cooperation in line with the rules of Sharia A. Bashir defines *mudarabah* as “a partnership between parties with money and a party with investment skills. Lenders supply capital to borrowers as agents (*mudarib*) for investment and trading purposes. Profits are divided in a ratio specified in the original agreement; losses are borne by lenders to the extent of their investment, in this eventuality the borrower/fund manager receives no reward for his efforts”. Therefore borrower provides human capital required for the success of the project, while the lender (*rabb al-mal*) provides financial capital and becomes a partner bearing a part of the risk. As a result human capital “is equalized” with the financial capital, while eliminating any pre-determined rate of return for either party<sup>11</sup>.

The profit and loss sharing principle’s conditions are met in such a transaction<sup>12</sup>.



<sup>10</sup> Shira J. Boss, *Loans, Interest Rates and a Religious Principle*, New York Times 2001, July 5, p. C7.

<sup>11</sup> A. Bashir, *Profit-Sharing Contracts and Investment under Asymmetric Information*, Research in Middle East Economics 1996, Vol. 1, pp. 173–186; M. El-Gamal, *Islamic Finance. Law, Economics and Practice*, Cambridge University Press, New York 2006, pp. 122–123.

<sup>12</sup> I. Warde, *Islamic Finance in the Global Economy*, Edinburgh University Press, Edinburgh 2001, p. 135.

Firstly, the financial capital is not borrowed mirroring the traditional Western credit facilities and does not have to be repaid after a certain time, together with an extra fee or interest. The capital is rather directly invested in the project by the lender. In case the venture proves profitable, the lender will receive its share of profits as compensation for the invested capital. However this gain will only be created by the assets purchased with the invested capital combined together with the work of the borrower. Profit will not be earned only due to the fact of investing capital<sup>13</sup>.

Secondly, the element of risk for lender is built into the partnership, as he can not require a specific, constant rate of return, but must be content with what the project earns. Nor can the lender take all the profit, since the agreement provides both parties with a share in it. After all, the “borrowing” party also invests its resources into the project – be it the time, knowledge or work – in order to obtain income. Such a structure equates the rights of both parties – capital lender’s resources are not considered more valuable and therefore demanding better security than the resources of the borrower.

However, the risk borne by each party is dependent on its contribution to business. Thus, the investor bears the risk of loss of capital invested in mudarabah while mudarib bears the risk of losing time and wasting their skills, if the activity proves to be not profitable. Expert (mudarib) can not be held financially responsible if it acted according to his best knowledge and skills, and was not negligent or conducting illegal business activities. In case, if his conscious behavior led to the loss, he is financially responsible<sup>14</sup>.

Sharing profits and losses becomes more and more popular due to the rapid development of stock exchanges. Indeed, through them investors own companies whose shares they have bought and can not be sure of profits which these shares will bring.

## PROTECTING ASSETS, SECURING TRANSACTIONS

Instruments assuring the protection of assets and transactions play an equally important role for the issue of equality in the Muslim culture.

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<sup>13</sup> R.T. De Belder, M.H. Khan, *The changing face of Islamic banking*, International Financial Law Review 1993, No. 11, p. 23.

<sup>14</sup> European law is also evolving in this direction. Examples are limited partnerships where the one partner brings knowledge and work to the company. The capital is brought however by another limited partner who bears the risk of losing his capital. If the company generates a profit – it is divided between partners according to preagreed algorithm, see, for example, Polish Commercial Companies Code, including: Z. Haque, *Riba. The Moral Economy of Usury, Interest and Profit*, Ikrq, Kuala Lumpur 1995, pp. 127 et seq.



They strengthen the confidence of cooperating parties in contracts. Such instruments can be divided into two main categories. Hedging instruments securing possible claims of parties based on the transaction and hedging instruments securing owners of assets against their loss or damage.

While in the Western economy, these groups of instruments are of utmost importance in reducing the risk that the parties are exposed to, in the Islamic economy the elimination of risk of the parties of the transaction is prohibited. Indeed, it is unacceptable to conduct a commercial transaction, or to participate in a manufacturing process and its benefits, without incurring the risk equally with other parties involved in a given activity. In accordance with these principles, the Islamic instruments have been designed to only better share the risk between market participants. Under no circumstances can they completely remove the responsibility and the business risks from either party.

At first glance, the Islamic insurance sector is no different from the classical Western insurance. There are insurance companies, customers, policyholders, premiums, risks, damages etc.<sup>15</sup>. However, a deeper analysis leads to the conclusion that the construction of insurance policies and the basic operational principles of insurance companies, or compensation mechanisms are completely different.

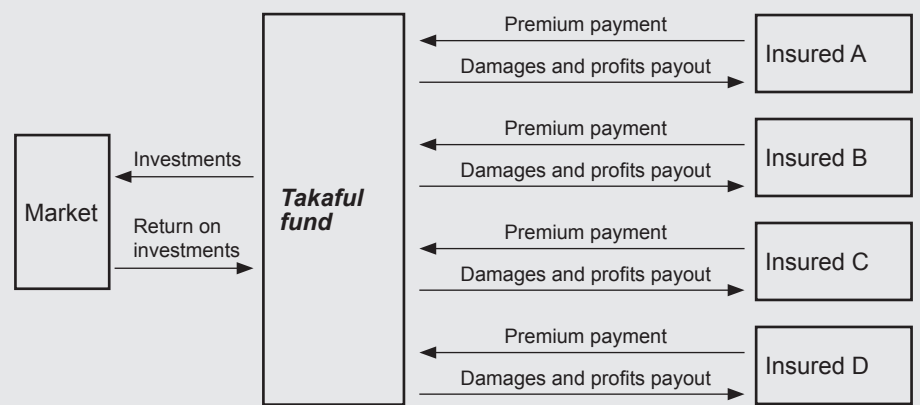
The main rule of this business is based on the integration of the policyholders into the insurance scheme using the profit and loss sharing structure. It can be named a principle of solidarity as well. The whole mechanism is based on the fact that policyholders do not purchase classical policies by paying premiums calculated based on the estimated risk. When purchasing an Islamic insurance policy the insured becomes a *muqaradah* shareholder of the insurance company. He pays in an adequate capital (the premium). According to his insurance contract a person or property is insured and in the event of a loss the company will pay out a compensation. Insurance company's capital (premiums) is invested in accordance with the guidelines of the Qur'an and Sunnah, using the instruments available on the Islamic financial market. If the insurance company generates a profit, a relevant share of it is paid out to the insured, because they act as shareholders.

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<sup>15</sup> On insurance contracts in Poland and Europe: see eg. E. Kowalewski, *Umowa ubezpieczenia*, Oficyna Wydawnicza Branta, Toruń–Bydgoszcz 2002; Z. Brodecki, *Prawo o kontraktach ubezpieczeniowych*, Kantor Wydawniczy Zakamycze, Cracow 2001; Malinowska K, *Umowa ubezpieczenia w Europie bez granic*, Oficyna Wydawnicza Branta, Bydgoszcz–Warsaw 2008. More on the integration of financial services in: K. Dąbrowska-Gruszczyńska, M. Gruszczyński, A. Wiczorkiewicz, *Integracja usług finansowych w gospodarce światowej*, in: *Ubezpieczenia w polskim obszarze rynku europejskiego. Wyzwania i oczekiwania*, Oficyna Wydawnicza Branta, Warsaw 2004, pp. 377–390.



FIGURE 4. STRUCTURAL MODEL OF TAKAFUL INSURANCE



Source: own analysis based on Ayub M., *Understanding Islamic finance*, Authorhouse, Wiley Finance, Chichester 2007 and Temple P., *Islamic Banking: Principles as Well as Roots*, Accountancy, 1992, No. 1187.

In the event of any damage to the assets of the insured (shareholder), the damages are paid out from the funds of the insurance company, thereby deducting it from the company's profits. The value of potential profits for all shareholders is respectively reduced. This mechanism guarantees that each shareholder contributes to the payment of compensation by sharing both profits and losses with other parties<sup>16</sup> (Figure 4).

Islamic insurance contract is therefore not only a simple policy protecting against possible risk, but also an investment facility, which may also bring huge profits to the insured. Such a mechanism thereby strengthens the essence of equality between all the participants<sup>17</sup>.

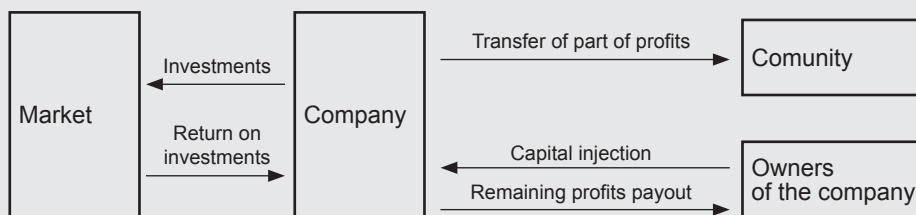
## PHILANTHROPY

*Zakat* means "purification" and is considered by Muslims as the main, crucial element of the social assistance system. It is both a way to help the economically weaker individuals, and a method of income redistribution in the society. Zakat or almsgiving is one of the five pillars of Islam. Though it is part of faith, it can be argued that this is a kind of religious

<sup>16</sup> M.A. Siddiqi, *Banking on Shari'ah principles*, Middle East, 2002, No. 325, pp. 34–37.

<sup>17</sup> M. Parker, *A policy with a dividend*, *The Times* 8<sup>th</sup> October 2003, p. 8.

FIGURE 5. STRUCTURAL MODEL OF ZAKAT



Source: own analysis based on Abdeen A.M., Shook D.N., *The Saudi Financial System*, John Wiley & Sons, New York 1984.

tax. The principles regarding the quantity, methods of collection or exemption from the obligation to pay were laid out already in the early days of Islam<sup>18</sup> (Figure 5).

The basic principle is that – every Muslim who has sufficiently large resources should devote a part of his wealth to help the society in the form of alms. Zakat is paid on income from commercial transactions and profits from agriculture and manufacturing. However, it is not collected from private property. There are also different rates of this “tax” depending on the tax base<sup>19</sup>.

*Zakat* has evolved since the beginning of Islam and by many scientists is considered as a basis, a cornerstone of Islamic economics<sup>20</sup>. It is an important, very effective and transparent instrument of wealth redistribution. However, today there are some doubts regarding its application. Should *zakat* be mandatory or voluntary? Should it be forwarded directly to those in need or rather should there be institutions that would act as intermediaries in the wealth transfer? What should be the amount of this “tax” and whether it should be independent from the subject and the object taxed? Currently there is no clear and universally binding interpretation on these issues.

Special case of public use instrument is waqf, which is nothing else than a voluntary philanthropic activity<sup>21</sup>. This means that the individual, who

<sup>18</sup> M. Zohurul Islam, *Islamic Economics*, Islamic Foundation Bangladesh, Dhaka 1987, pp. 152 et seq.

<sup>19</sup> See also: A.M. Abdeen, D.N. Shook, *The Saudi Financial System*, John Wiley & Sons, New York 1984, p. 205.

<sup>20</sup> I. Warde, *Islamic Finance in the Global Economy*, Edinburgh University Press, Edinburgh 2001, p. 145.

<sup>21</sup> Also, the classical models of corporate social responsibility in the Western economic thought suggest the importance of philanthropic responsibility being at the top of the hierarchy of responsibility, after the economic, legal and ethical accountability. “The scope and nature (of the philanthropic account-



Equality

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possesses assets of significant value can finance an investment (an asset of substantial value and with long duration – usually property), which will then be utilized to fulfill a socially useful function. A construction of a mosque, school or hospital can be an example. Such buildings are needed by the Muslim community. However, their existence and activities performed in them should not be profitable, hence they need to be financed through waqf by wealthy members of the community.

Waqf is characterized by two fundamental features. First, it is infinite in time. Secondly, it must be voluntary and consistent with the objective of the donor.

## FINAL THOUGHT

Many economists think that the Islamic financial instruments and the principles of Islamic economics is a return to conservative, referring to axiology, rule-making business. One may not share these values, but the fact is that this phenomenon is a clear demonstration of the growing importance of ethics and equality in the business. The principle of sharing profits and losses, investments in fixed assets and ensuring transparency of the relations between the contracting parties may be a solution for an “unbalanced” economy and the financial sector.

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tability) are voluntary. It is not defined by any legal standards, or even ethical, but only by social expectations that the company decides to meet” – more on this subject see: K. Łudzińska, *Spoleczna odpowiedzialność przedsiębiorstw i jej wpływ na budowę wartości*, in: A. Szablewski, *Migracja kapitału w globalnej gospodarce*, Difin, Warsaw 2009, pp. 366–392.