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Islamic Finance, Ownership Risk and Right to Yield

Gaps in Theory and Practice

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Abstract: From a *shariah* perspective, the rights and obligations of parties in exchange contracts are determined based on the different underlying contractual structures. Among the key *shariah* principles that provide conceptual premises for determination of yield-entitlement from an investment, include the principles of *al-kharaj bil-dhaman* and *al-ghunm bil-ghurm*. According to these two principles, in order to be entitled to a financial return or yield, the owner of an underlying asset, activity or capital must bear the related market as well as ownership risks. These two principles have a great bearing on how the *shariah*-compliant banking and financial activities are conducted. In the context of Islamic Financial Institutions (IFIs), the requirement of *dhaman* exposes IFIs to a new form of risk i.e., ownership risk. To this effect, IFIs in different capacities need to assume ownership-risk to justifiably claim a financial return from a financing activity. Notwithstanding this, in the customary practices of IFIs, there are noted discrepancies in the application of the *dhaman* principle. The objective of this paper is to examine the application of the *dhaman* principle in different contractual structures of IFIs, followed by highlighting the existing gaps between the theory and practice in applying this concept. The research adopts a qualitative research approach in order to examine the issue. The paper is based on a review of relevant literature and adopts a textual analysis method. The paper argues that if there is a discrepancy in application of *dhaman* principle, the *shariah* status of the resulting yield may be affected. Among the key implications of such a discrepant application of *dhaman* concept include allocation of yield to a non-deserving party; the party which practically shifts the underlying *dhaman* of the relevant contract rather than absorbing it. As a policy recommendation, the paper suggests strategies to re-align the practice of Islamic banking with its theories, particularly, with reference to directing the relevant risk to the one who claims the yield.

Keywords: Islamic banking, shariah, ownership risk, urf, customary practices, interest.

JEL Classification: B10, D20, D40, E22

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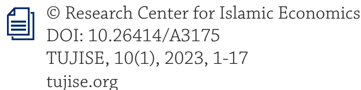

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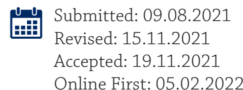

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Introduction

The premises of modern Islamic banking practices lie, primarily, in the *shariah* prohibition of interest (*riba*) (Abdullah & Sarwar, 2019). Interest, in the context of banking and financial services, is defined as a stipulated benefit or increment for the lender over a loan (Abdullah, 2015). The source of this commonly understood definition of interest is a Prophetic *Hadith* which holds 'each loan which entails a (stipulated) benefit for the lender is (tantamount to) interest'[1]. In view of this, there is no scope of expecting a yield out of a loan contract, as stipulating a return over a lent amount becomes impermissible in *shariah* (Abdullah, 2015). In comparison, there is no *shariah* prohibition of expecting or securing a financial return or yield from an investment activity (Abdullah, 2021). Thus, *shariah* permits earning profit over investment, but disallows a contractually stipulated increment over a loan amount (Abdullah, 2021). For a layman, there may arise a confusion over the rationale of the two different rulings. In other words, there is scope for a blurred understanding on the reasoning of this apparently discrepant treatment of a loan-offering vis-à-vis an investment activity in *shariah*. In this background, the question is that why funds given to a counterparty under the contract of a loan is not allowed to yield a return, whereas funds advanced under an investment contract is allowed to do so. To demystify this phenomenon, delving into the *shariah* framework of contracts, and understanding the *shariah*-basis for determining rights and obligations of parties is critical.

From a *shariah* viewpoint, the difference in treatment of funds offered as a loan vis-à-vis funds advanced as a part of investment, lies in the status of their ownership and the related risks, rights and obligations. Whereas, in view of *shariah*, the ownership and the related risk (*dhaman*) of the capital in a loan (*qard*) contract transfers from the lender to the borrower, the *dhaman* of capital in an investment contract rests with the capital-provider (Abdul Razak & Saupi, 2017). To simply put it, a loan constitutes a *dhaman* contract which entails a liability on the borrower for a guaranteed repayment of the capital to the lender. In contrast, an investment-oriented contract belongs to the category of *amanah-based* (trust) structures, entailing a fiduciary duty upon the counterparty, but without any liability to either capital protection or its guaranteed yield. The guarantee aspect of a loan provides a cover to the lender from being exposed to either risk of ownership or to market risk; a composite of which makes the basis for the principle of *dhaman* in *shariah*.

1 The original *hadith* wording is 'كل قرض جر منفعة فهو وجه من وجوه الربا' (Sunan al-Bayhaqi Hadith 5/350). However, in the literature, the commonly referred wording for this is 'كل قرض جر نفعا فهو ربا' (Abdullah, 2015).

On yield entitlement, the *shariah* stand is clear that it belongs to the one who is liable to the *dhaman* of the underlying capital or asset in a contract (Zuhayli, 2003). At the root of this *dhaman* principle lies the concept of *iwad* (due compensation or consideration), which is deemed as the backbone of Islamic normative theory of profit. Broadly, *iwad* in *shariah* represents a legitimate consideration of capital or *amal* (action) (Benaicha, 2020). Arguably, the *shariah* rationale to treat a *dhaman*-based contract differently from an *amanah*-based contract, in terms of yield entitlement, lies in the conceptual differences of *dhaman* versus *amanah* rules (Gamal, 2006). As such, the party that bears the ownership as well as related market risks of the capital, is entitled to receive its yield. This *shariah* principle is premised on the famous *shariah* maxim which holds 'Yield/return is justified by assumption of liability/ risk (*dhaman*)' (al-Tirmidhī, 1975). The origin of this *shariah* maxim is a prophetic *hadith* which refers to the case of a sale, whereby the buyer had requested to return the subject matter of the sale to the seller due to some identified fault in it. Against this, the seller claimed that the buyer had unjustifiably benefitted from the subject matter during the already passed period of the sale. On this, the Prophet observed '*al-kharaj bil dhaman*[2]' which simply means that the buyer's benefit was justified, as it is he who bore the risk of ownership during this period i.e., had the subject sold item been destroyed during this period, it would have been the loss of the buyer (Abu Dawood, 1999). From this originated the understanding among the jurists from a *shariah* perspective, that one becomes entitled to yield of an underlying capital, asset, service or usufruct, in a contract, only upon assuming its liability and ownership risk (*dhaman*) (Hamza & Qazzafi, 2019).

In terms of practical implication of this principle, since it is the borrower who bears ownership risk under a loan contract, it is he who enjoys the right to any subsequent yield from the borrowed capital rather than the capital-provider i.e. lender. In contrast, in an *amanah*-based contract, since the liability to market as well as ownership risk is borne by the capital-provider i.e., the investor, it is he who is entitled for any subsequent yield from it as a legitimate *iwad* (consideration) of assumed liability (Elgari, 2003). Hence, the two different parties – capital-provider in one, and capital-recipient in another – enjoy the entitlement to yield in the given two contractual settings.

In consideration to the *dhaman* principle of *shariah*, Islamic Financial Institutions (IFIs) employ various investment-based contracts for generating a justified yield for the depositors as well as for their share-holders (Ahmad, 2000). The

2 The original Arabic wording is 'الخراج بالضمان'

normal impact of this adoption manifests in directing the liability of market and ownership-risk of capital to the respective fund-providers and investors. To this end, the clauses of relevant contract documents as employed by IFIs are drafted in a way that they indicate this i.e., the risk (*dhaman*) of investment is borne by investment-based fund-providers. Thus, apparently, the requisites of *dhaman* are satisfied for investment-based products of IFIs through incorporation of ownership and market-risk related clauses in the respective contracts.

Notwithstanding this, in the customary practices of IFIs, the practical implication of *dhaman* principle rarely manifests in its actual sense to the respective owners of funds. Rather, apparently, the application of this principle is shrewdly shrouded or circumvented by IFIs. This is done to adjust the pitch of IFIs' offerings to the offerings of their conventional counterparts in terms of matching their risk-reward profiles for fund-providers. Thus, despite the presence of market and ownership-risk related clauses in the contract documents, in practice the actual *dhaman* is either shifted to or is held by a party which is not envisaged to be burdened with this risk. To this end, the application of *urf* (customary practices) principle helps lift the mask from the face of a cleverly packaged *dhaman* which is practically diverted to a party that is not supposed to assume this within the prism of *shariah*-based normative theory of profit. In view of such customary practices, the *shariah*-permissibility of receiving the resultant yield in such a contract may be called into question.

This paper aims to analyse the concept of *dhaman* in exchange contracts, and attempts to contour the frame of its application in Islamic financial practices. Thereafter, the paper attempts to examine the *shariah* position on practical application of *dhaman* principle at IFIs. Finally, the paper provides an overture to prevalent-practices of IFIs in dealing with *dhaman* followed by identifying the existing lacuna in its application. The paper argues that if there is a contradiction between the formal stipulations of a contract and their customary practices, the *shariah* status of such an issue needs to be decided based on the customary practices, and not on the basis of its apparent form in the contract.

Research Methodology

The paper is an outcome of a library-based research, and it employs a qualitative research based on a textual analysis approach to develop the argumentation. For the analysis, the primary and secondary sources of *Shariah* are referred to. The paper reviews the relevant Islamic jurisprudential literature and analyses the concept of

dhaman in *Shariah* and its practical implication for different exchange contracts at IFIs. The paper is divided into four sections. Section one provides the introduction of the research. Section two examines the concept of *dhaman* in *shariah* and its application. Section three analyses the Islamic financial practices from the prism of *dhaman* and *urf* requisites. Finally, section four concludes the paper with some findings and relevant recommendations.

The Concept of *Dhaman* (Risk/Liability to Loss) in Shariah

The emergence of modern Islamic banking industry as well as *shariah*-compliant financial alternatives is rooted in two central ideas namely; urge for *shariah*-compliance in financial dealings and call for bringing equity and justice in transaction contracts (AAOIFI, 2015). Achieving these two is, according to its proponents, possible by structuring contracts consistent with *shariah* principles, and by directing the underlying rights and obligations of different contracts to the right party in line with the relevant *shariah* requisites (Abdullah, 2020). In the discussion of maintaining equity and justice in contracts, the principle of ownership-risk and liability to loss (*dhaman*) appears to occupy a critical status. In practice, this principle of *dhaman* plays a decisive role in sketching the skeleton of contractual relationships under the Islamic financial architecture (Askari, Iqbal, Krichene, & Mirakhor, 2012). At the heart of *dhaman* principle lies the concept of *iwad* (legitimate consideration), upon which the Islamic normative theory of profit is premised. As per the concept of *iwad* (return in an exchange contract) in *shariah*, a consideration must be matched with a fair countervalue, action or risk assumption. In the context of a *shariah*-compliant investment, *shariah* permits an investor to justifiably claim a financial return or yield from the invested capital as an *iwad* against his /her assumption of *dhaman* (the risk of capital).

Contrary to general perception, the concept of *dhaman* in Islamic finance does not always imply risk-sharing. Rather, the principle of *dhaman* sketches an appropriate criterion to direct the risk of ownership and liability to loss to the correct party of a transaction. An application of this concept in practice is allured to be the point of distinction for the Islamic financial practices over conventional finance in practical terms. In a broader sense, the concept of *dhaman* lays the conceptual ground for the often-referred *shariah*-prescribed idea of risk sharing vis-à-vis risk shifting in financial dealing (Dusuki, 2008). The risk-shifting versus risk-sharing argument gained its roots in Islamic finance in consideration to the following two

famous *shariah* maxims; '*al-gunm bil ghurm*[3]', and '*al-kharaj bil dhaman*[4]' (Laldin et al., 2013). The gist of these two shariah maxims is that, in shariah it is not only provision of capital per se which justifies reward-entitlement, rather, it requires accepting the *dhaman* of the capital as well to justifiably claim any yield from it (Ariff, Iqbal & Mohamed, 2012).

In view of this *dhaman*-related *shariah* requisite, the capital provider under a loan contract is disallowed to make a benefit or yield, as he does not assume the relevant risk of capital upon loan disbursement. Rather, it is the borrower who becomes liable to repay the capital irrespective of whether he/she makes a profit on its usage or suffers a loss (Abdul Razak & Saupi, 2017). In other words, the liability to capital repayment is immediately shifted to the borrower on loan disbursement, and it is he who bears its *dhaman*. And, so, the borrower becomes entitled to reap the respective benefits or yields actualized out of it, rather than the lender. To this effect, as, it is clear that a lender is not entitled to a yield or return from the capital, structuring a loan-based contract in a commercial setting becomes meaningless for IFIs.

Though, IFIs employ loan-based (*qard*) contracts at their liability-side, its usage is limited to only such products which do not offer any yield or financial return to fund-providers (Abdullah, 2015). Among the most commonly offered products structured on the concept of *qard* is a current account which is necessarily free from any profit or reward. This practice is coherent with the resolution No 86 (9/3) of the International Islamic Fiqh Academy which stipulates that "Demand deposits (current accounts) whether in Islamic or traditional banks are loans in the strict *shariah* sense. The receiving bank holds such deposits under guarantee and is committed by Shariah to repay them on demand" (IIFA, 1995). On the status of the funds under current account, the AAOIFI Shariah Standard 40/2/2/1 holds that "such amounts represent loans which the institution has to guarantee their repayment on demand without any increment. The institution has the right to dispose of such amounts and invest them for its own benefit and under its own responsibility" (AAOIFI, 2015).

In view of the strict position of 'no yield or increment' on a loan, IFIs find it suitable to employ this contract on their liability side only, but abstain from deploying this on the asset side, evidently for commercial non-viability of its employment for financing. This practice of avoiding usage of a loan-based contract is natural for IFIs as they conduct financing activities with a profit motive, and,

3 The original Arabic wording is الغنم بالغرم

4 The original Arabic wording is 'الخراج بالضمان'

as such, offering products through contractual structures which do not allow them making profit is not suitable to business policy of IFIs. Alternatively, IFIs utilize different other *shariah*-based contracts which are intrinsically characterized with a profit-orientation (Iqbal, 2013). In the list of such contractual structures include equity-based, leased-based, sale-based and agency-based offerings. The shariah-rationale to treat these modes differently in terms of allowing profit-making through them is based on the idea that these contracts do not entail a guaranteed capital repayment e. g. these contracts warrant tying *dhaman* of capital with its provider. In other words, these contracts link the risk of capital with the fund-providers, something that justifies generating a yield for them in a *shariah*-compliant manner (Hanif, 2010).

Based on *dhaman*-related *shariah* prescription, employing investment-based contracts to develop financial products is a common practice at IFIs. Consequently, due to adopting investment-based contracts with an in-built *dhaman* tied with the fund-providers, the resulting rights and obligation of parties under different such contracts change at IFIs (Usmani, 2008). The implication of this shift in paradigm is that IFIs must assume risk exposure to generate a return from a financing instrument. Thus, IFIs appear to assume the risk of underlying goods in a *Murabaha* (cost plus profit) contract prior to its sale, risk of property in an *Ijarah* (lease) contract till maturity, risk of capital contribution in a *Mudaraba* (profit and loss sharing) and *Wakala bil-Istithmar* (investment agency) contracts as well as risk of its proportionate share in a *Musharaka* (equity) contract etc.

Nonetheless, despite being incorporated in the legal documentation, most often, it appears that the *shariah*-rules of *dhaman* are covertly subverted or distorted in practices of IFIs. As a result, the *dhaman* of an underlying capital, asset or subject matter of a contract is, in effect, shifted from the financiers to the fund-recipients. As such, the fund-providers are practically protected from liability to loss as their rights are ring-fenced without genuinely exposing them to the risk of ownership or liability to loss. In view of this practice, the justification to yield-entitlement for the capital-provider is shadowed with doubts and question-marks from a *shariah* perspective. The following part of this paper critically analyses the dubious practices of IFIs in terms of complying with the *shariah*-requisite of *dhaman* and its implication in their financial activities.

Dhaman, Prevalent Practices (Urf) and Right to Yield

Among the primary objectives of Islamic financial institution's offering is to avoid involvement in interest (*riba*) in all its forms; be it in an overt or a covert manner.

Riba (interest) can possibly permeate in a transaction as an explicit stipulation or an implicit practice (Abdullah, 2019). Whereas stipulating an outright payment of interest over a loan is the example of its explicit form, seeking a guarantee of capital from the investment agent on the invested capital constitutes its implicit manifestation. With reference to stipulating guarantee of capital from the investment agent, AAOIFI Shariah Standard 23 holds, "guarantee by the agent entails a suspicion of *Riba* (usury) (AAOIFI, 2015). Therefore, the status of the agent as a trustee contradicts with the provision of guarantee". Based on this *shariah* standpoint, combining an agency with a guarantee in a contract is deemed impermissible.

From another angle, combining an investment agency with a guarantee from the agent leads to *riba* because in doing so the *dhaman* of the capital will shift from the principal (fund-owner) to the agent, which contradicts the shariah rule of yield-entitlement for the principal. In an investment agency, the capital-provider bears the risk of loss, and, so, is entitled to its yield. To ensure the implication of this rule in practical terms, *shariah* requires establishing *dhaman* prior to undertaking a transaction even from commingled funds. AAOIFI Shariah Standard 23 holds;

> "If the agent co-mingles his own funds with the principal's funds or with funds that he manages, he may not then purchase, for his own account any assets from the assets owned by the commingled funds without giving notice on each occasion. This is to establish the transfer of ownership and liability for the asset from the commingled funds to the agent's account" (AAOIFI, 2015).

The requirement of *dhaman* establishment in the above scenario is not but for removing the scope of doubt on who holds the liability to underlying assets and the resulting risk of loss, and thus the party that bears this risk should be entitled for its resultant yield. In applying this principle, no party will be able to unduly claim a right over the yield of a transaction. Evidently, the *shariah* rationale of this principle is based on the concept of *iwad* which ensures equity and justice for the transacting parties. And, the given rationale of *shariah* is actualized only if this principle of *dhaman* is applied at IFIs in its letter and spirit. However, a close inspection of the prevalent practices at IFIs will reveal that the application of the given principle of *dhaman* is restricted to letter only with the exclusion of its spirit. This is so as in practical terms the financier seldom assumes the true *dhaman* by itself in a true sense other than displaying its assumption ostensibly. Rather, the same is diverted to clients needing funds. This is done through shrewdly crafted clauses and wordings of relevant documents as part of an overall stratagem to duck an overt collision with the *shariah* rules. To this effect, let us take the example of a financial *Ijara* which is commonly known as *Ijara muntahiya bil tamlik* at IFIs. The

original *shariah* rule regarding an *Ijara* is that the lessor owns an *Ijara* property, and hence by implication, it is he who bears the risk of its ownership as well as the liability to its major maintenance (*dhaman*). In the letter and form, this rule is well honoured in relevant *Ijara* documents. However, in spirit and practice, the *dhaman* of the underlying asset is directed to the lessee through various ruses. No doubt, this is done with a tacit understanding and agreement between the parties.

In general, the diversion of de-facto *dhaman* to the lessee manifests in practical terms once there occurs an incidence of a major maintenance or a partial destruction in the underlying *Ijara* property. In view of the original *shariah* rule, the lessor being the owner should bear the *dhaman* for this. However, in practice, the cost of such an incident is borne by the lessee. Thus, in effect, this practice makes the lessee to assume the ownership risk and the related liability of the underlying property on a de facto basis. To give this practice of transferring the de facto *dhaman* from the lessor to the lessee a *shariah* legitimacy, a subterfuge or *shariah* cover is used in a tactical manner. For this, a *shariah* cover is discreetly employed by introducing three different tools. These include (a) a service agency agreement, (b) a supplementary rentals clause in *Ijara* contract, and (3) a purchase undertaking from the lessee to purchase the property at an exercise price. A combination of these three tools give effect to what can be arguably called 'shifting of *dhaman* from the lessor to the lessee'.

To unpack the impact of these three tools, an inspection of the eventual result emanating from the application of these three tools is critical. For this, one needs to simply examine and locate the party which is eventually at risk of losing if there happens an incidence incurring any additional cost towards maintaining the underlying property. For example, one needs to check that who is at risk of losing if there occurs an increase in the insurance cost of the property, or in property tax, or if there happens an incidence of major maintenance. The result of this examination will practically determine the party that is bearing the actual *dhaman* of the leased property. From the practices of IFIs, in general, it is not difficult to conclude that irrespective of what is in the contract, eventually, it is always the lessee who is at loss in all these scenarios of additional cost incurring incidences. This is so as, practically, the lessee ends-up paying these costs from its own pocket although under the guise of service agency. For *shariah*-conditioning of this practice, IFIs ensure inclusion of 'supplementary rental' concept in the *Ijara* contract, according to which IFIs become entitled to add a supplementary rental as a separate component of the total rentals in each *Ijara* period. Afterwards, IFIs appoint the lessee itself as the service agent of *Ijara* property by executing a service agency agreement. According to this agreement, the lessee takes care of all major maintenance, on behalf of

the lessor, in the capacity of a service agent. Thus, once there occurs an additional expense for any major maintenance in the property, this is borne by the service agent, on behalf of the lessor, for which the agent becomes entitled for refund from the lessor. However, this entitlement for refund is neutralized by adding the same costs as supplementary rental of subsequent *ijara* period. As a result, the lessor becomes entitled to collect the same amount from the lessee as supplementary rental in the succeeding *ijara* period. Finally, the two entitlements are set-off between the parties with the net effect of lessee ending-up bearing any additional expenses of insurance premium, increased property tax or the cost of major maintenance required to maintain the underlying leased property.

To extend further protection to the lessor against the ownership as well as related market risk of the property, IFIs secure a purchase undertaking from the lessee at the outset, according to which the lessor keeps the right to force the lessee to purchase the property at an exercise price which is generally the sum of the total cost-plus profit amount for the IFI. Such exercise price is calculated through a pre-determined formula which is agnostic to the prevalent price of similar properties in the market. In this way, the market risk in the form of property-price volatility is shifted to the lessee right from the commencement of the lease. Finally, in case of a partial or total loss of the property, due to any reason, if the insurance proceeds happen to be insufficient to cover the loss, the service agent (lessee) is generally deemed negligent for this, and hence is held liable to indemnify the lessor for any shortfall. The end result of this practice renders the lessee to bear the *dhaman* of the property, though in an implicit manner. In a nutshell, as per the prevalent practices of IFIs, arguably, since it is the lessee who ends-up bearing the de-facto *dhaman* of the underlying property, the claim of lessor over the lease rentals seems contradicting the *iwad*-based Islamic normative theory of profit in a lease contract.

Interestingly, a similar pattern of *dhaman*-shifting is witnessed in the practices of investment Sukuk as well. For example, the case in point is that of an investment agency-based (*Wakala bil istithmar*) Sukuk structure, whereby the obligor sells a portfolio of *shariah*-compliant assets composed of tangible and intangible revenue-generating properties/assets to the special purpose vehicle (SPV), which represents the sukuk-holders. Conceptually, once the sale/purchase is executed, the sukuk-holders become the proportionate owners of the purchased portfolio. Thus, by implication, the liability to ownership-risk moves to sukuk-holders proportionately. In this scenario, according to the original *shariah* position, the yield of the sukuk should be based on the performance of the underlying portfolio of assets, and it should reflect in the periodical revenue distribution amount to the sukuk-holders. Similarly, being owners of the portfolio assets, the *dhaman* of any

fluctuation in the market-value of the underlying assets shall be borne by the sukuk-holders. However, in practice this is not the case, as a similar stratagem is again resorted to, for protecting the sukuk-holders from being exposed to the real *dhaman* of the assets. This is materialised by creating a tactfully-weaved web of legal documents, contractual clauses as well as through introduction of concepts such as liquidity-facility in the relevant sukuk prospectus.

In terms of documents, a mix of service agency agreement along with purchase and sale undertakings provide the leeway to protect the sukuk-holders from various forms of *dhaman*-related risks. So far as the clauses of documents are concerned, they are drafted in a way that the fund-recipient (obligor) is eventually held liable on the ground of 'negligence' for any underperformance of the portfolio assets, or in case an insufficient *takaful* claim is received. In terms of liquidity facility, its provision is generally included in the legal documents, according to which the obligor is generally envisaged to arrange a *shariah*-compliant liquidity facility in case a shortfall occurs in the periodical proceed distribution amount to sukuk-holders. Though such a liquidity facility is voluntary in nature and, being based on shariah concept of *qard*, is recoverable from the subsequent proceeds; in practice it hardly remains a voluntary exercise for the obligor. To sum it up, the applied ruses rarely leave any scope of *dhaman*-exposure to the sukuk-holders, as, in effect, the same is diverted to the obligor.

Similar practices of *dhaman*-shifting are witnessed in some Islamic trade financing instruments as well. Consider, for example, the case of a *Musawama*-based Islamic export financing mechanism. In this, an exporter, having an order for shipment of specific goods from an importer, approaches to an IFI to apply for export financing. Based on the application, the IFI offers financing by purchasing the subject goods from the exporter on a *Musawama* basis (bargain-sale), and appoints the exporter itself as its undisclosed agent to sell and ship the goods (on behalf of the IFI) to the importer with an added margin over cost price. In this, the original *shariah* rule is that once the IFI has purchased the goods from the exporter, the *dhaman* of the goods as well as the risk of any subsequent transaction in it shall transfer to the IFI. To this end, conceptually, the role of the original exporter becomes that of an agent who sells and ships the goods to the importer in the capacity of IFI's agent. However, this is not so in practice, as the IFI protects itself from such *dhaman* by securing an independent undertaking from the exporter for reimbursement of the sale price if the importer defaults. Though, this is done in a tactful manner to avert any explicit collision with *shariah* principles, the end result of this practice manifests in loading the exporter with a de-facto *dhaman* of the deal, while rendering the IFI free from risk of the transaction.

Interestingly, the practice of *dhaman*-shifting is not always one-sided to favour the IFIs only, rather, at occasions this is exercised to save other parties too from their exposure to *dhaman* of capital and its underlying risks. The treatment of *Mudaraba*-based investment accounts, for example, is the case in point here. According to the original *shariah* rule, in the normal course of activities, the *rab-al-maal* (capital provider) in a *Mudaraba* contract is liable to bear 100% risk of capital loss. Thus, there is no scope of guarantee for either capital protection or fixed yield in a *Mudaraba*-based investment. However, in practice, this is rarely observed. As the IFIs playing the role of *Mudarib* (entrepreneur), for the management of *Mudaraba*-based funds, they employ a combination of strategies to render the real *dhaman* ineffective for the *rab-al-maal,* both in terms of capital protection, as well as in securing the expected rate of return.

To accomplish this, IFIs deploy various tools and ruses at different levels of transactions. At the first stage, an expected rate of return is announced on *Mudaraba*-based accounts, which attract the account-holders to the offerings of IFIs. At this stage, through various means, a tacit understanding is created among the account-holders for certainty of gaining the expected rate. At the second stage, different reserve pools are created to safeguard the account-holders from any exposure to risk of capital or yield loss. Finally, the conceptual framework of a probable discretionary gift provision from the shareholders' account is added to provide a cushion to the *rab-al-maal* for security of capital as well as the yield from risk of loss. Though, from a juristic point of view, this exercise is not in a direct conflict with any *shariah* rule, the customary prevalence of this practice fuels scepticism on its modus operandi. This not only neutralises the whole concept of *dhaman* for the *rab-al-maal*, but through this, the *dhaman* is effectively shifted to the *mudarib* who becomes compelled to absorb the investment-related shocks to avoid any possible incidence of a displaced commercial risk.

In view of the above discussion and analysis, it is argued that in various Islamic financial offerings, the IFIs' practices of diverting *dhaman* from the original owner of funds or assets is witnessed. Such practices ignite scepticism on the legitimacy of yield-entitlement for the party which effectively remains absolved of true *dhaman*. In the form, the *dhaman* is tied with one party of the transaction, however, in practice, the prevalent usage of stratagems shifts such *dhaman* to another party. In this context, to check and confirm who is eventually bearing the *dhaman* in practical terms, reference should be made to the *urf* (customary practices and norms). In *urf*, if it is tacitly understood and known that the fund-provider – be it at liability side of the balance sheet or on the asset side – enjoys a de-facto surety on its capital as well as a practical guarantee to its yield, while the relevant risk of capital/asset

are diverted to the recipient of the fund, questions on *shariah* legitimacy of such practices are certain to arise. This also calls into question the applicability of the *shariah* axioms '*al-kharaj bil-dhaman*' and '*al-ghunm bil-ghurm*'.

A litmus test to confirm who effectively bears the *dhaman* of an underlying capital or asset in a transaction at IFIs can be conducted by simply examining and identifying the party which is eventually impacted by an under-performance of a project or loss of market value in a given transaction. To simplify this, consider the question, for example, that in an *Ijara*, who is exposed to risk of loss if an unexpected major maintenance occurs at the underlying property, or if the market-value of the property substantially depreciates? Is it the lessor or the lessee? In the same vein, in Sukuk, who is impacted if the total revenues generated from the investment *Wakala* portfolio of Sukuk fall short of the expected yield, or if the market-value of the underlying composition of the portfolio slumps? Is it the Obligor or the Sukuk-holders (principal/owner)? Similarly, in a *Mudaraba*-based investment account, who is practically exposed to loss if the *Mudaraba* pool underperforms or various counterparties default at IFIs' asset-side? Is it the account-holder (*rab-al-maal*) or the IFI (*Mudarib*)? Perhaps, the answer to these questions will enlighten the existing gaps in the theory vis-à-vis practices of modern Islamic financial infrastructure.

To sum it up, in line with the approach of AAOIFI that "Traditionally acceptable conditions resemble explicitly stated conditions" (Shariah Standard 25), this paper argues that in assessing the treatment of *dhaman* in the practices of IFIs, the concept of *urf* (prevalent practices) cannot be simply disregarded. To this effect, there are instances in classical *fiqh* where the shariah status of a transaction is decided by referring to the *urf*. For example, classical *shariah* scholars held the view that lending in a region or locality where it is in *urf* (an established customary practice) for the borrowers to repay an excess over loan is tantamount to involving *riba* (Abdullah, 2015). Drawing an analogy from this, it can be argued that ensuring a clearly-defined *dhaman* and its practical bearing by the right party of the transaction, should be a pre-condition for shariah-compliance of a transaction at IFIs. This shall be strictly followed in regions where it is a *urf* to effectively divert the actual *dhaman* to other than the owner of the funds or assets. As, linking *dhaman* with the one party in legal documents, but shifting it to another party in practice becomes tantamount to misapplication of *dhaman* principle. And, this practice may affect the *shariah* status of the yields received by the owners of funds/assets from such transactions.

Notably, it is not that the practices of *dhaman* shifting at IFIs are employed by keeping the shariah scholars, shariah standard setting bodies or the relevant

regulators in a dark on this front, rather these practices enjoy a tacit approval of these bodies. The rationale for approval of such practices may vary as per the understanding and interpretation of *dhaman* concept and the requisites of its practical application by different such entities. Apparently, from amongst the most prominent rationales to approve such practices include the argument that there is a necessity to keep a close proximity of risk and reward profiles of Islamic financial instruments with their conventional counterparts in order to accommodate the market demands. Though such a rationale may be acceptable from the perspective of remaining competitive, keeping the system stability or garnering a wider acceptability; the permissibility of such practices at IFIs seems directly pitched not only against the Islamic normative theory of profit, but also against the well-established shariah principle of *dhaman*.

Conclusion

The objective of *shariah*-compliance entailing equity, fairness and justice in exchange transactions is at the heart of Islamic financial industry's modern emergence. According to *shariah* philosophy, this objective can be achieved by curtailing the scope of exploitation and injustice in various forms of bilateral deals. *Shariah* puts a complete ban on exploitative tools such as charging or paying *riba* (interest), and provides a framework to clearly demarcate the rights and obligations of transacting parties in a transaction. The *shariah*-provided framework of transactions lays the ground for fair treatment of parties in a deal. Among the key component of this framework include the principle of yield entitlement, which determines the rules for being entitled to the yield of an investment or of a revenue-generating asset. According to this principle, the entitlement to yield from a capital or an asset accompanies assumption of ownership risk of the underlying asset. This principle is premised on the shariah-based concept of *dhaman* (ownership risk), which is derived from a prophetic *hadith*.

As per the *shariah* framework of transactions, an investor is entitled to the yield generated from the investment of his/her underlying capital, but a lender is not. At the centre of this varied treatment of an investor vis-a-vis a lender in terms of yield entitlement lies the concept of *dhaman*. According to the *dhaman* concept, receiving a return or yield from an investment becomes justified for the capital-provider as it is he who bears the ownership-risk of the capital. In contrast, claiming any yield from the capital of a loan (*qard*) is impermissible for the lender as he no longer remains liable to the risk of underlying loaned item once a loan contract is concluded and the fund is disbursed. Instead, the risk of ownership and

liability to loss of loaned amount transfers from the lender to the borrower. Thus, it is the borrower who bears the risk of underlying capital after the loan disbursement, and hence becomes entitled to any subsequent yield from it.

Keeping in view this *shariah* parameter, IFIs avoid usage of the loan contract at their asset side, as the same cannot be employed to generate any financial return for the financier. As an alternative, IFIs employ different other suitable *shariah* concepts to develop their financial products, so that they can generate yield from financing activities. Among the suitable concepts for this purpose include sale-based, lease-based, investment-based and agency-based structures to name a few. To this effect, the set of documentation employed for these contracts are drafted in consideration to the *shariah* requirement of *dhaman* concept. Consequently, the relevant contracts hold clauses implying that the *dhaman* of the underlying capital or assets are associated with their respective owners. However, contrary to what is contained in form, the substance of such clauses remains effectively unchanged. To actualise this in practical terms, IFIs deploy a few stratagems to shift the actual *dhaman* of capital, as well as the *dhaman* of an underlying property to the recipient of the funds. As a net effect, the fund-provider or financier remain almost immune to the risk of ownership in the whole process. It is not that the parties of these contracts are unaware of this practice, rather, they readily accept this practice considering it as an accepted customary practice (*urf*). The premises for the tacit understanding of IFIs' client that the *dhaman* and its pertinent implication has to be absorbed by the recipients of the capital instead of financiers is generally sourced from their acquaintance with the practices of conventional financial institutions. Consequently, as a practical norm, the recipients of financing are effectively tied with the underlying *dhaman*.

This paper argued that the existence of a contractually agreed, yet practically ineffective *dhaman* for the original owner of an asset or capital, may raise *shariah* concerns on the validity of yield entitlement to the risk-shifting party. In other words, despite incorporating a *dhaman* in the contract for the original owner, shifting its de-facto effect to another party puts a question-mark on *shariah* compatibility of such practices. The paper highlighted a few examples of how the *dhaman* is shifted at IFIs from the financiers to the recipients of the funds through usage of multiple ruses. The paper found that practices of shifting *dhaman* of ownership from the owner of the assets to the recipients is more prevalent in *Ijara* and investment Wakala-based products. The paper proposes conducting a litmus test to find out who ultimately bears the *dhaman* in different Islamic financial transactions at IFIs. To this effect, the example of an *Ijara* case was presented to test whether it is the lessor or lessee who effectively bears the *dhaman* of ownership in an *Ijara*. For this,

simply examining the party that is eventually at loss if there occurs a cost-incurring incidence at the property or the market value of the property slumps. Is it the lessor (fund-provider) or the lessee (fund-recipient) who practically loses in these situations? Similarly, in an investment *Wakala,* be it in the context of a Sukuk or in a term deposit product, the question is that who eventually loses if the underlying investment activity underperforms. Is it the fund-provider (principal) or the fund-recipient (agent)? In consideration to the *shariah* maxims *'al-kharaj bil-dhaman'* and *'al-ghunm bil ghurm',* the result of this test may have serious *shariah* implications on yield-entitlement to the fund-providers in these scenarios.

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