

# Gharar in Mudarabah

**Mohammad H. Fadel**

Gharar (*in the context of mudaraba*) is in the compensation given to the agent (al-'amil), which is entirely contingent on the success of the venture. This becomes clearer if you compare the rights of the agent in a mudaraba arrangement to two other possible contractual arrangements that could be used to effect the same transaction: a partnership (musharaka) or a hire-contract. In each of these alternatives to mudaraba, the labor of the agent is given a fixed-value up front, and accordingly, if the venture is a failure, his losses are mitigated. In the case of a partnership, the losses of the partnership are borne proportionately by each partner. In the case of a hire-contract, the losses from the venture are borne exclusively by the person hiring the agent. In the case of mudaraba, the losses are borne first by the agent, in the form of a lack of compensation. The investor only loses if the overall value of the venture declines to less than its initial book value.

To take an example, suppose the value of the labor is 10, and the financial capital is 100. The owner of the capital could simply hire the agent for 10, and whatever profits are earned accrue exclusively to the contributor of financial capital. If they decided to form a partnership, the overall value of the partnership would be 110, with the agent owning 1/11 and the owner of the financial capital owning the remaining 10/11. They would share profits and losses according to that percentage. In a mudaraba, the agent would presumably be entitled to receive 1/11th of the venture's profit, which would result, on a going forward basis, in the same return to him as he would receive from the partnership. If the venture loses money, however, he would have been better off had he entered a partnership. Suppose that after one year, the venture is disbanded and its liquidation value is 90. If this were a mudaraba, the agent would be entitled to receive zero, even had he worked diligently. If it had been a partnership, however, he would receive  $90 \times (1/11)$ , or approximately 8.2.

Accordingly, it is possible, using classical Islamic contracts, for the same worker to receive remarkably dissimilar payouts, despite the fact that he is doing the same work, based on the contingent nature of the contract. Because mudaraba allows (actually requires) that the agent's pay off be contingent, it is an exception to the rules prohibiting gharar. Presumably, however, if we get beyond legal formalities, a rational agent in a mudaraba contract would only prefer this mode of contracting to the other two where he has dramatically superior informational advantages over the contributor of capital. This informational advantage, presumably, justifies overlooking the gharar inherent in the contract.

Note: as a legal matter, the agent in the mudaraba has no claims to the financial assets of the venture, and for that reason, his return is viewed by the jurists as that of an employee.

**M T Fadzil**

Let's get back to basics of Mudharaba.

A Mudharabah is a contract of agency, whereby the capital owner (Rabbul Mal) engages the entrepreneur or fund manager (Mudharib) to invest the capital. The mudharib is not allowed to get paid a predetermined fixed amount regardless of the outcome of the venture. However, both the Rabbul Mal and the Mudharib will have to agree on the percentage of the earnings to be shared between them. In case of a profit, they share according to this ratio.

But in the case of a loss (presumably not through the negligence of the Mudharib), the Rabbul Mal will bear it in full. All the mudharib loses is his futile effort.

The difference between a Mudharabah and a Musharakah, is that the partners of a musharakah share the profits according to a pre-agreed ratio and losses according to their capital contribution, In a Mudharabah, while profits are being shared in a pre-agreed ratio (between Rabbul Mal and the Mudharib), losses are borne fully by the Capital contributor.

Therefore in comparing the outcome of the two (Mudharabah and Musharakah), one simply cannot put a value of labor & capital as it is based on mutual agreement between the contracting parties. Thus, in my opinion, the statement,

*"In a mudaraba, the agent would presumably be entitled to receive 1/11th of the venture's profit, which would result, on a going forward basis, in the same return to him as he would receive from the partnership. If the venture loses money, however, he would have been better off had he entered a partnership,"*

is somewhat flawed. In a partnership, if labor is considered part of the capital contribution (and thus given a value), then in the event of a loss, the partner who contributes only labor would have to bear his share of the loss.

I still do not see the element of gharar in a valid Mudharabah.

**Mohammad Nejatullah Siddiqi**

I think brother Fadel needs to note the following:

When he says 'borne proportionately by both partners' he should actually say proportionately to capital supplied by each partner. This would make him realize that in a partnership both partners must come with some capital. If one comes with labor only and the other comes with capital, such a 'partnership' will be called 'mudaraba'. He says; 'suppose the value of labor is 10'. He should note that a supposed value cannot take the place of capital in partnership. This error makes his example wrong. It will be good to look up fiqh rules relating to shirkah (partnership) and mudarabah (profit-sharing). For non-Arabic-knowing brothers my small book, :Partnership and Profit-Saring in Islamic Law, published by the Islamic Foundation, Leicester, UK, may be useful.

## Muddassir H. Siddiqui

Please note that, under the Islamic law of partnerships, one is not allowed to “suppose the value of his labor” and then use that value as equivalent to or in lieu of his financial contribution in determining his share in the profit of the partnership. If one partner is contributing nothing other than his labor, then the rules of Mudarabah shall apply. He will not get any profit unless the joint venture makes a profit. This basic misunderstanding of the rule of the Shari’a makes your analogy incorrect.

## Mohammad H. Fadel

*(Response to M Nejatullah Siddiqi)*

Brother Siddiqi makes the point that in classical Islamic fiqh, as a general matter, a partnership could not be formed where one partner contributes assets (whether in cash or in kind) and the other contributes labor. In a sense, that only exacerbates the problem of gharar inherent in mudaraba (from the perspective of the employee), since he would not be allowed to contribute his labor as part of the assets of the firm. In fact, however, Brother Siddiqi ignores muzara'a (share cropping). In this partnership arrangement, the labor of the farmer was considered to be part of the capital of the partnership. Strictly speaking, muzara'a is considered an exception, i.e., a "rukhsa", but in terms of economic function, there can be no doubt that it was the most important cooperative arrangement in pre-modern, agrarian Muslim societies. Furthermore, jurists have used the example of muzara'a as an *asl* on which *qiyas* was performed to permit other partnerships in which one side contributed only labor. I have discussed one such arrangement that arose in 13th-14th century Andalusia in connection with silkworm cultivation. Maliki jurists approved this partnership on the argument that it was analogous to muzara'a, even though in principle, one is not allowed to extend a *rukhsa* using *qiyas*.

In any case, it seems that recognizing muzara'a as an *asl* that can be used to permit labor to be recognized as a capital input (and not simply a cost) is at least as consistent with classical Islamic jurisprudence as other transactions being discussed today.

## Habib Ahmed

I don't think 'state contingent compensation' of the *mudarib* by itself would constitute *gharar*. While *gharar* has been translated in various ways in English, it is different from market risk. According to Al Dhareer *gharar* exists either in the essence or terms of the contract or in the object of the contract. The former would be the case when there is uncertainty of whether something will take place or not and the consequences of a transaction are not clear. Examples of these would include two sales in one, the toss sale, suspended sale, and the future sale. *Gharar* in the object of the contract will occur when the subject matter of sale does not exist or the seller and/or buyer do not have the knowledge of the object being sold.

I think gharar is more related to legal risks and (asymmetric) information problems rather than business risks. Thus, according to the above definition an example of gharar in a mudarabah contract would be not having the profit-sharing ratio fixed ex-ante. If all the conditions of a valid contract are fulfilled and the mudarib engages in a venture knowing the inherent risks involved, then the state contingent compensations would be normal business risks that the parties to the contract agree to take.

### **Lamaan Ball**

Here is a suggestion for the meaning of gharar in English: "Deceptive Ambiguity". Sometimes an ambiguity may, through assumptions on the part of the liable party lead to deception and the liability may not in fact be what he thinks it is. There are many examples, where this can be said to occur. I could for example agree to sell you the fruit from my tree and you may assume that the tree is of a normal size and producing a reasonable amount of fruit. But then you will discover that the tree is immature and produces very tiny fruit that are basically useless. The assumptions you made here are being used by me to trick you into an agreement. The key to avoiding this is in explicitly stating every assumption in the contract. This is implicit in the Qur'anic instructions of contracts with future liabilities where small and large matters should all be reduced to writing.

Islamic finance is simple economic justice. Do not over complicate it. Gharar, maysir and riba are just kind of liabilities, which are liable to change and therefore subject to doubt. This invalidates full mutual consent, which is the basis of fair and free trade. Gharar (uncertainty) is just vagueness in a liability that can be exploited to trick people into thinking they are getting a better deal than is actually the case. Maysir (gambling) is just an explicit change in liability, which the liable party has no control over. Riba (usury) is just a punitive increase in liability, which the liable party may have no control over.

The goal of Islamic finance is the establishment of economic justice through ensuring the minimum of doubt about what the liabilities of contracts are. There are inevitably risks in any contract with a future liability because we don't know what the future may bring. However, this is not up to the law to eliminate this in any way. It is up to traders to find ways to better predict the future and thereby prepare for it and mitigate their risks. Islamic law about trade and finance is essentially nothing but ensuring mutual consent by avoiding doubts through explicit fixed liabilities.

So, on the subject of agents being paid on a shared profit basis the question is: how is the profit determined? In business, the determination of profit is a rather arbitrary affair in many ways. If I own a small business, I can pay myself a director's salary and that can eat up all the income of the business. Alternatively I can simply claim the money as a profit. It is like that joke about the accountant: when asked how much is  $2 + 2$ , he answers "how much do you want it to be?"

If the pay of the agent is simply a commission on things that are sold then that is much clearer and avoids much of the deceptive ambiguity of "profit sharing". However, even this may involve some problems if the amount of labor needed to achieve a sale is unclear.

The way to avoid this latter issue is probably just to ensure that the contract allows the person to stop working at any time if he feels it to be a waste of his time and effort.

### **Mohammad H. Fadel**

I am surprised by the resistance to a very simple concept. According to Muslim jurists, the wage of an employee must be fixed in advance by the contract. Otherwise, there is gharar. For that reason, they said that mudaraba is an exception to that rule. The important point about my hypothesis is that because the agent in a mudaraba contract is not an "owner", he is the party that bears the risk of failure up to the value of his labor. The "owners" have no risk unless the negative return is in excess of the value of the labor. On the other hand, in a partnership where the labor is given value as capital, that loss would be borne proportionally. I reiterate the point I made earlier that in muzara'a, labor was treated as an item of capital, so it's not inconceivable that jurists could have required a more restrictive contract in mudaraba. The point simply is that when a contract is efficient, in my opinion, jurists classically looked the other way at gharar.

### **M. Yusuf Saleem**

I think it may clarify the issues if we treat each contract separately. The contract of ijarah (employment), the contract of wakalah (agency), the contract of mudharabah, and the contract of musharakah are separate contracts.

In ijarah the wage of an employee should be fixed. An employee has to act in accordance with the instructions of the employer. An employee's job is also specified. An employee is entitled to his wage irrespective of the loss or the profit that the business may make.

An agent, on the other hand gets his commission and not a salary. He may or may not get his commission depending on whether the job is done or not.

A mudharib is not an employee. He is considered an agent of the sahib al-mal but the contract is not wakalah. A mudharib becomes a partner in the profit the percentage of which is pre-determined.

In musharakah the partners are agents to each other but the contact is not wakalah. The partners share both profit and loss. If a certain partner contributes to the management of the partnership he may receive a greater percentage of the profit.

In contrast, in common law partnership the labor is considered a form of capital and in case of loss the one who contributes labor has to suffer financially. In mudharabah the emphasis is more on the protection of the party who contributes labor. However, this labor ('mal) is not specified, while in case of employment the service that an employee has to render is well-defined.

Muzar'ah and musaqat where one of the parties contributes only the labor could be discussed together with mudharabah rather than musharaka.

## Mohammad H. Fadel

*(Response to Lamaan Ball)*

There are two ways of discussing gharar: normatively and descriptively. You are propounding a normative theory of gharar that is much narrower than that used by the jurists, which is fine by me. We just ought to be clear that this would be a substantial departure from existing Islamic legal concepts regulating contractual uncertainty.

## Anwer Khan

Can you expand on this distinction between descriptive and normative discussions of gharar?

I personally feel that the key to Islamic Finance is for Muslims to develop a notion of consent that can be applied meaningfully to financial transactions. Riba jahiliyya happens when consent is obtained under duress, and gharar is when the person is not quite able to give consent as he doesn't know the terms or the object of trade well enough (possibly due to deception). In years past, we've tried to look at the bases for the rulings of riba and gharar ... yet people seem reluctant to reflect on the points made. Given that every financial contract entails the exchange of risk, a broad definition of gharar - applied strictly - makes us unable to use financial contracts (like insurance). Some people work at the margins of the law by using hiyal. Others opt out of the legal system altogether, and don't use financial contracts (witness takaful). It's odd that they invoke the distinctive philosophy of Islamic brotherhood while doing this, but are very particular about their labor contracts. All that this means is that part of our legal system (finance) is broken.

There is also the matter of riba al-fadl ... I will endeavor to post references to published works by Shafi'i jurists of the past century who viewed this as a devotional rule and questioned its relevance to dealings in fiat currencies.

I think that the difficulty in discussing such matters amongst the Islamic Finance crowd is that these people are mostly self-selected to revolutionize the world's financial system, and are predisposed to consider western financial dealings as illegitimate. They and their jurists need to demonstrate objectivity and intellectual honesty. A near-consensus amongst a closed group of like-minded Muslims means little.

## Lamaan Ball

Your last paragraph interests me most because it represents one of the key weaknesses in the development of Islamic jurisprudence. "A near-consensus amongst a closed group of like-minded Muslims means little."

Unfortunately many jurists after the development of *usul ul fiqh* treated such near consensus as a source of shariah. People have however disagreed about this source. I

don't intend here to go into it at length. For me, there is only one consensus that matters and that is a consensus on how to reach political decisions. This is due to the principle "amruhum shurah bainahum" which means "their decisions are by mutual consultation". Consensus is the conclusion of mutual consultation - if there is a conclusion. So, consensus is a form of evidence used for reaching community decisions.

Now, there is a close relation between "law" and "decision" but what has happened is that many people have taken Shariah to be simply God's law and therefore unchangeable. In such a concept we are left with nothing to decide. This is not true. Shariah is our interpretation of God's law. Some things in that law are explicitly commanded by God but the vast majority is a matter of our choice of interpretation and hence open to our decision making process, open therefore to mutual consultation. Consensus as a basis of evidence merely points to the ambiguity of other forms of evidence such that it requires us to make a decision. Facts are true regardless of what a large group of people think about them.

Consensus is not for deciding upon facts. Consensus is only for deciding upon acts. Judge opinions by the facts, don't judge the facts by opinions.

### **Mohammad H. Fadel**

Briefly, a descriptive account of gharar would simply be an attempt to explain the historical rules of gharar as adumbrated by the jurists. A "good" theory would be one that "fits" the evidence of the cases.

A normative theory is one that, although based on the descriptive theory outlined above, explicitly moves beyond previous doctrine, attempts to produce a synthesis of its tensions and contradictions, and proposes a new way of viewing gharar based on a moral/economic principle.

For example, you are proposing (by implication) that a new theory of consent underlies what gharar should mean to modern Muslims. I would call that a normative theory based on liberal conceptions of autonomy. I tend to view gharar more from the perspective of social welfare -- transactions should be permitted, despite gharar, where the proposed transaction is socially efficient (on Kaldor-Hicks basis as well as Pareto, in the case of a bilateral contract) and the cost of the risk is minimized. A typical case from my experience is environmental indemnity clauses -- because of the strict liability regime applicable in the US to environmental liability, buyers of property (as do lenders receiving security in real property) typically receive indemnity from the selling party for claims or losses arising out of any subsequently discovered environmental condition on that land. Under classical fiqh, that clause could not be enforced because of gharar (neither party has any knowledge as to whether there is an environmental condition that will lead to a claim or a loss, and if so, how much it will cost). Nevertheless, in principle, I think we should be comfortable with it because of two reasons: first, the seller is clearly in a better position to assess the magnitude of this risk relative to the purchaser, and second, the seller, as a result of the threat of liability under the indemnity, will conduct reasonable investigations

to determine whether there are any hidden conditions in the land requiring remediation. As a result, the contractual provision, despite the fact that it is laden with gharar, actually results in the reduction of uncertainty at the lowest cost to society. (It would not make sense from a social perspective to require prospective purchasers to undertake this investigation because it would result in unnecessary investment in the production of the same information. The seller does the analysis once and then can make it available to all prospective purchasers.) However, at the end of the day, the liability is still unknown, and the gharar is not removed, only minimized to the extent possible.

I should also note that the prospective trade in the land is not the origin of the risk, which distinguishes it (and the way gharar arises from commercial contracts) from ordinary gambling; the risk of an undiscovered environmental condition is there whether or not the parties do the trade. That should be the same reason we should not have a conceptual difficulty with insurance in general. It may very well be that cooperative insurance is more optimal than bilateral insurance as some on this list have argued, but I don't think Islamic law should prohibit contracts solely on the basis of perceived suboptimality, if it is clear that the contract makes both the contracting parties better off and does not include externalities that would offset the gain accruing to the contracting parties.

### **Anwer Khan**

*(Response to Mohamad Fadel)*

One thing that troubles me about the work of the jurists involved in Islamic finance is that their theory of gharar is not clear and is not given much discussion.

In the past, I believe that you've tried to link this focus on social welfare to trends in the work of later jurists such as Shatibi. Is this correct? The philosophy I was working with is perhaps inspired by sacred texts that insist on trade based on mutual consent. One might see a connection between these two perspectives in the welfare theorems of economics, which link complete markets with the maximization of social welfare.

It should be noted that financial markets tend to have difficulties (such as informational problems) that weaken this link. Perhaps Prof. El-Gamal can comment on this.

### **Mahmoud A. El-Gamal**

I agree with Dr. Fadel that forbidden gharar should best be linked to welfare optimization in the Pareto/Kaldor-Hicks sense. One point to add, however, is that transactions costs associated with potential legal disputes play a significant role in this calculus (with all due respect to the legal profession, a legal dispute results in a dead weight-loss for the contracting parties, and society at large -- of course, the potential positive role played by the legal community is to reduce the frequency of such disputes). Thus, we find that jurists oftentimes speak of "al-gharar al-mufdi lil-niza" (the type of gharar that may lead to legal disputation) to justify a prohibition. Other types of (minor) gharar are forgiven, and as Al-Baji Al-Andalusi would say, no economic activity can be completely void of that type of

gharar. More recently, Malaysian jurists have allowed futures trading, on the basis that the gharar in such transactions is not the type that can lead to disputes: futures exchanges have clearinghouse rules that remove that form of substantial gharar.

In this regard, I don't agree with Br. Khan on information considerations necessarily causing problems to this association of forbidden gharar with efficiency-reducing legal dispute. One can think of two types of informational problems: those associated with future states of nature, and those associated with asymmetric knowledge of attributes. In the latter case, one would worry about tadlees (cheating) more than gharar (e.g. in the land deal examples discussed by Dr. Fadel), which can be treated statistically in a manner analogous to the first source of information incompleteness (dependence on chance). The problem in this case is that one can talk about ex ante as well as ex post efficiency. Except in highly regulated industries (e.g. insurance, with actuarial scientific methods), there is a high possibility that ex post disgruntled parties to the contract can dispute the deal and its underlying processes. Unless the economic surplus generated by the deal is sufficiently high to overcome the potential dead weight loss associated with this dispute, the transaction should not be allowed. To the extent that transparency of the contract, the underlying stochastic processes, and resolution of uncertainty mechanisms, can reduce the potential dead weight losses (as in the case of futures exchanges), perhaps the gharar, which was once deemed significant can now be deemed minor (thus overturning classic jurisprudence rulings as Malaysian jurists have done).