eabh Papers | No. 14-07 | July 2014

In the Name of God: Managing Risk in Islamic Finance

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Abstract:

In *Against the gods: the remarkable story of risk* (1996), Peter L. Bernstein illustrates how the mastery of risk has driven modern Western society into converting 'the future from an enemy into an opportunity'. Far from being an antagonist, as the unpredictable whim of gods or mysterious fate, this story has transformed the future into a human prospect, where risk is quantified, measured and managed to mitigate the perils of the unexpected, and where risk-taking, -transfer and -pooling have become per se sources of legitimate profit. Commenting on Bernstein's work while moving from the Western 'risk' to the Arabic رزق *rizq*, '(God's) sustenance', this paper dares looking at human hazard, زهر *zahr*, the 'dice' of future chances, through a comparative and inter-cultural perspective. More precisely, it aims to show how specific anthropological assumptions result in an alternative theory and practice of risk management in a market whose peculiarity is to operate not 'against' but 'in the Name of God': the market of Islamic finance.

To this end, Islamic finance is depicted within an anthropology of time where not only the future, but also the present are a divine (rather than human) creation, and where, consequently, risk is deeply re-framed both as a concept and as a source of legitimate profit. In fact, to the extent to which the future remains an economic opportunity in Islam (Q. II:275: 'Allah has permitted trade'), it is not conceived as a human product but as a part of man's responsibility to perform *Shari'ah*, as God's agent in the 'real'/'right' (*haqq*). Thus, while any legitimate profit follows liability (*al-kharaj bi-l-daman*), risk management coherently endorses the primacy of the real economy, exchange equilibrium (with any unlawful increase from *riba*, *gharar* or *maysir* being prohibited), and profit-loss sharing. In other terms, if risk continues to hold an economic value in Islamic finance, this value exists only as legitimate profit (*kharaj*) through liability (*daman*), and remains linked to asset-based and commercial activities. As a result, the logic underpinning Islamic banking and insurance (*takaful*), as well as securities (*sukuk*) trade, becomes hardly comparable to the conventional one, and rejects financial products, such as derivatives, that are deemed lacking in any commercial value since nothing 'real' is actually traded.

To conclude, the paper remarks on how this alternative history of risk in Islam requires further consideration in financial theory and regulation, for the benefit of a level playing field where both conventional and Islamic finance are able to co-exist and prosper under the same (God's) sky.

JEL Classification: Islamic finance; risk management; anthropology of risk; comparative economic history.
Keywords: A12; N20; N25; P48; Z12.

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> ‘The word “risk” derives from the early Italian *risicare*, which means “to dare”. In this sense, risk is a choice rather than a fate. The actions we dare to take, which depend on how free we are to make choices, are what the story of risk is all about. And that story helps define what it means to be a human being.’
>
> Bernstein (1996, p. 8)

1. Gods, men and the (un)expected: from Bernstein’s risk to the Arabic **rizq** *(رزق)*

Peter L. Bernstein’s extraordinary book *Against the gods: the remarkable story of risk* has been able to popularize and make accessible to the general public the intricacy of a concept, that, as he remarks, ‘touches on the most profound aspects of psychology, mathematics, statistics, and history’ (p. ix). The volume itself won the Edwin G. Booz Price for the most insightful, innovative management book in 1996, as well as the Clarence Arthur Kelp/Elizur Wright Memorial Award in 1998; not really unexpected, considering this success, *Against the gods* has sold over 500,000 copies worldwide.

Indeed, dealing with the (un)expected is what risk management is all about: something that Bernstein defines as that ‘revolutionary idea’ shaping modernity, where, far from being an antagonist, as the unpredictable whim of gods or the mysterious fate, the future has become an opportunity. Moving away from the fear of the unexpected, his volume tells us about

> ‘[…] the story of a group of thinkers whose remarkable vision revealed how to put the future at the service of the present… [converting] risk-taking into one of the prime catalysts that drives modern Western society. Like Prometheus, they defied the gods and probed that darkness in search of the light that converted the future from an enemy into an opportunity. The transformation in attitudes towards risk management unleashed by their achievements has channelled the human passion for games and wagering into economic growth, improved quality of life, and technological progress.’ (p. 1)

From Fibonacci’s *Liber Abaci* (1202), Cardano’s *Liber de Ludo Aleae* (1525) and Galileo’s *Sopra le scoperte dei dadi* (1623), the astonishing story of risk developed in Western society through the laws of probability framed by Pascal, Fermat and Chevalier de Méré (Bernstein 1996, pp. 57-72), and the science of statistics of Graunt, Petty and Halley, fostering the development of insurance as a commercial concept in the eighteenth century (p. 92). It was in that time, with Bernoulli’s paper on *Specimen Theoriae Novae de Mensura Sortis* (1731), that risk-taking was related not only to objective facts but also to a ‘subjective view about the desirability of what is to be gained, or lost, by the decision’ (p. 100).[1] From this perspective, if

> ‘Cardano, Pascal, and Fermat provided a method for figuring the risks in each throw of the dice, … Bernoulli introduces us to the risk-*taker* - the player who chooses how much to bet or whether to bet at all. While probability theory sets up the choices, Bernoulli defines the

[1] Daniel Bernoulli, in fact, introduced the revolutionary idea that ‘the *value* of an item must not be based on its *price*, but rather on the *utility* that it yields’, which varies from person to person (Bernstein 1996, p. 99; italics in the original text).

> *motivations* of the person who does the choosing. This is an entirely new area of study and body of theory. Bernoulli laid the intellectual groundwork for much of what was to follow, not just in economics, but in theories about how people make decisions and choices in every aspect of life.' (p. 108; italics in the original text)

From that time onwards, through Gauss' normal distribution (p. 136), Poincaré's study of information and decision-making and Bachelier's analysis of speculation (p. 200), the theory of risk has further advanced through Arrow (p. 204), Knight and Keynes' notion of risk as 'measurable uncertainty' (p. 219). An uncertainty whose source can be found in others' intentions, as explained by Von Neumann, Morgenstern and Nash's game theory (pp. 232, 235 and 243); and whose measure has led financial theory to well-known concepts such as portfolio selection, diversification, the capital asset pricing model (Markowitz and Sharpe, p. 260), the Black and Scholes formula (pp. 304 ff.), and to prospect theory in behavioural economics (Kahneman and Tversky, p. 270).

Of course, this very concise introduction to Bernstein's book does not even distantly mirror the richness of its contents: the interested reader will find in *Against the gods*, and its broad bibliography, much better satisfaction of his intellectual enquiries. But, at least superficially, this summary highlights how centuries of extraordinary intellectual elaboration in Western society transformed the future from an antagonist into a product of a (human) present where risk is quantified, measured and managed to mitigate the perils of the unexpected. Accordingly, within this cultural setting, activities of risk-taking, -transfer and -pooling (i.e. banking, investment, insurance, or even gambling, businesses) have become in the West a source *per se* of legitimate profit, where, in the (extra)ordinary enterprise of risk management, as we know it today, the 'gods' are left aside.

But from where does the idea of 'risk' come from? And how much does it explain about human nature, given that its story, in the end, is all about '[t]he actions we dare to take' and 'how free we are to make choices'?

If the Latin *resecare*, *resicum*, *risicum*, *riscus* are the direct precedents for the Italian *risicare*, meaning 'to dare', and *risco* (from which the current Italian *rischio*, the French *risque*, the English *risk*, the Spanish *riesgo* and the German *Risiko*, all derive), a more ancient etymology of the word 'risk', in contrast, remains uncertain. The Latin forms may have derived from the Greek *ριζα*, meaning 'root', 'stone', 'cut of the firm land', which was also used as a metaphor for a 'difficulty to avoid in the sea' (in this sense, for instance, Skjong 2005).[2] For the ancient Greeks the uncertainty of survival in the Mediterranean was caused by the whims of gods like Zeus and Poseidon, and the 'stone' of the firm land as well as the 'root' of a tree were symbolic images of a lifeline, securing the sailors from the perils of the sea. Quite interestingly, the classical Greek *ριζα* seems to find (at least phonetically) an equivalent in the Arabic *rizq* (رزق), from which the word 'risk' may derive, too: the term may have been absorbed by ancient pre-Islam Arabic from Greek, via Mediterranean contacts, or vice-versa. The rich legacy of such contacts is also witnessed by the word 'hazard', that moved into English from the French

[2] Indeed, it is of interest that 'these lexical borrowings happened in the end of the middle-ages, when mentalities woke up and people dared to discover the world. So that from the 16th century on, the term got a benefit meaning, for example in middle-high-German *Rysigo*… a technical term for business, with the meaning "to dare, to undertake, enterprise, hope for economic success".' (Skjong 2005)

hasard and the Spanish *azar*, both (certainly) coming from the Arabic زهر *zahr*, meaning 'dice', thus the chance of human luck (Bernstein 1996, p. 13).[3]

But, apart from this digression on probable linguistic transmissions through the Mediterranean, if *rizq* on the one side expresses the idea of 'fortune', 'profit', 'gain', 'blessing' (thus, safety from the perils of life, as in the etymology of *ριζα* and later 'risk'), on the other side, and quiet remarkably, this fortune is depicted and conceived in Arabic language in the particular sense of 'a sustenance that is given by God for livelihood' (Wehr 1994). Accordingly, the verb *razaqa* is always used in the sense of 'God providing somebody with means of subsistence'; الرزا *ar-razzaq*, 'the Maintainer', 'the Provider' is one of the ninety-nine attributes of God; and مرزوق *marzuq* is the 'person blessed by God', thus 'fortunate', 'prosperous', 'successful'. At a very preliminary glance, therefore, the secular nature embedded in modern Western 'risk' stays far apart from the Arabic *rizq*, where the future and its fortunes are given by God.

To the extent to which the phonetic connection between the Greek *ριζα* and the Arabic *rizq* may been tentatively suggested and is certainly thought-provoking, it seems to me that their distant meanings may also offer a clue (or at least an intellectual temptation) to broaden Bernstein's history of risk by adopting a comparative perspective, moving from the Western to the Arab side of the Mediterranean by looking at the hazard, زهر *zahr*, the 'dice' of future chances, through an inter-cultural approach. In other terms, does a different anthropology of risk characterize Islam in comparison to the West? Should we tell, in this regard, a story of risk different from Bernstein's? And, if this diverse story is still to be told, how much may it help us to 'define what it means to be a human being' in a Muslim context?

Indeed, today the investigation on *ριζα*/*rizq* is far from being purely speculative and confined to comparative linguistics or the domain of intellectual conjectures. On the contrary, it can be directly related to the development of a niche of the financial system whose outstanding peculiarity, to Bernstein's surprise, is to operate not 'against' but 'in the Name of God': namely, the market of Islamic finance.

In this direction, challenging the perils of the Mediterranean in the search for another root of safety from the unexpected (the ancient Greek *ριζα*), this paper dares to look at human fortune in the light of the Arabic *rizq*, and investigating how a diverse anthropology of risk in Islam may actually result in alternative practices of risk management, as manifested today by *Shari'ah*-compliant financial institutions.

Thus, the Islamic financial market and its peculiar principles (prohibitions of *riba*, interest; uncertainty and speculation, *gharar*; gambling, *maysir*) will be depicted within an anthropology of time where not only the future, but also the present, are a divine (rather than human) creation, and where, accordingly, risk itself is deeply re-framed both as a concept and as a source of legitimate profit. Indeed, to the extent to which, as we will see, in a reality created directly by God the future remains an economic opportunity (Q. II:275: 'Allah has permitted trade'), any legitimate profit follows from man's responsibility (*al-kharaj bi-l-daman*) in performing *Shari'ah* by participating in the

[3] Both the Greek *ριζα* and the Arabic *rizq* (رزق) may even find a common Indo-European or Semitic root (a hypothesis of ancient comparative linguistics which is, of course, far beyond my expertise and the aims of this writing). Speaking of risk (and my personal risk-aversion), anyway, I would not put my money neither on *ριζα* nor رزق as the very first origin of the term and its related meaning(s).

divine creation of the 'real' and as an 'agent' of the only 'Actor'. It is this dual canon of 'participation' and 'agency' that coherently implies a conceptualization of risk in Islam, which is focused on the primacy of the real economy; exchange equilibrium (with any unlawful increase due to *riba*, *gharar* or *maysir* being prohibited); and profit-loss sharing (§ 2).

As a result, alternative rationales rule risk management in Islamic finance. In fact, while risk continues to hold an economic value, this value is linked to real assets and business activities through the assumption of liability ('profit follows responsibility', *al-kharaj bi-l-daman*), leading to fundamental peculiarities in the practice of Islamic banking, insurance (*takaful*) and securities (*sukuk*) trade that can hardly be compared to conventional ones, as well as rejecting financial products, such as derivatives that are deemed lacking in any commercial value since nothing 'real' is actually traded (§ 3).

To conclude (§ 4), the paper will remark how this alternative story of risk would require further consideration in financial theory and regulation, for the benefit of a level playing field where conventional and Islamic finance would be able to co-exist and prosper under the same (God's?) sky.

2. Islamic finance, Muslim anthropology and legitimate profit: **al-kharaj bi-l-daman**

Islamic finance has recently experienced increasing visibility as an ethical alternative to conventional business (Tripp 2006), as well as exceptional growth in GCC and South-Asian countries (above all, Malaysia), with an average growth rate between 10 and 20 per cent in the last decade (TheBanker 2013). At any rate, while forming a promising niche in the Middle East and Asia, at present its market share is only around two to three per cent of total transactions at a global level; moreover, as far as Europe and the West are concerned, the United Kingdom, as the largest national market (after Turkey), still attracts only a marginal percentage of *Shari'ah*-compliant assets, despite the favourable regulation fostered by the local government (for an overview, see Ercanbrack 2013).[4]

From a historical standpoint, modern Islamic finance finds no precedent in the Muslim society of the past, which did not experience institutionalised credit institutions such as the European banks of the Middle Ages. As shown by Udovitch (1970), financial support in classical Islam was mainly supplied by informal capital providers or by credit-labour partnerships for commercial activities. In contrast, the birth of contemporary Islamic finance relates to a flourishing academic literature on Islamic economics, from the '70s onwards (see, for instance, Chapra 1979; Siddiqi 1976 and 1983), and to the first experiments of Islamic banking in Egypt, under the liberalization programme by President Sadat, the *Infitah* ('open-door') policy (Mayer 1985).[5] While these preliminary examples of Islamic finance were primarily driven by purposes of social cohesion

[4] In this light, the enthusiasm shown by Western scholarship towards Islamic finance as a 'key dimension of the relationship between Arab banks and their European counterparties' (Wilson 2007, p. 8) seems quite premature.

[5] In order to uphold social mobility by facilitating the access of the poor to credit, the government licensed Nasser Social Bank (1971) and Faysal Islamic Bank (1977), that had their precursor in the Mit Ghamr Savings Bank (licensed by Nasser in 1963 and closed in 1968), deemed to be the first historical experiment of modern Islamic banking. While observing Islamic precepts in their operations (mainly the prohibition of interest, *riba*), these banks were primarily concerned with realising social aims by providing credit to segments of Egyptian society that, otherwise, would not qualify for loans (Mayer 1985, p. 49).

through enlarging the access to credit for the poor, it was during the '80s that a more advanced industry developed under the criteria of *Shari'ah*-compliance, moving from a restricted domain into larger commercial practice.[6] At present, Islamic financial institutions offer to the generality of customers (Muslim or not) an immense variety of products, from investment-deposits (so-called PSIAs, profit sharing investment accounts) to *takaful*, lit. 'guaranteeing each other', the Islamic risk-shared insurance model aimed at avoiding 'uncertainty' (*gharar*); as well as equity fund management and Islamic securities (*sukuk*).

In compliance with *Shari'ah*, fundamental peculiarities characterize Islamic financial transactions, whose validity requires, apart from the avoidance of prohibited investments (such as alcohol, pork, pornography), the elimination of any profit deriving from an 'unlawful increase', that is to say, interest (prohibition of *riba*), unreasonable uncertainty (ban of *gharar*) and gambling (*maysir*) (Saleh 1986; Cattelan 2009).

These rules necessarily result in a favour towards asset- and equity-based financial instruments and a corresponding dismissal of both debt-based products (likely to produce *riba*) and hazard-affected securities (*gharar*, *maysir*). More precisely, since conventional loans are essentially gratuitous in Islamic law (due to the prohibition of *riba*), ordinary interest-bearing credit transactions are replaced in Islamic finance by asset-backed contracts, such as *murabaha* (mark-up or cost-plus sale), *salam* (advance purchase), *istisna'* (commission to manufacture) and hire-and-sale (*ijara*); or by equity-based instruments such as *mudaraba* (silent partnership) and *musharaka* (full partnership). In both cases (asset-backed or equity instruments), legitimate profit has to derive from the necessary assumption of a liability correlated to a reference entity, according to the fundamental principle *al-kharaj bi-l-daman*, that is to say, *profit* (i.e. the chance of gain, in the sense of what is someone's due, what someone deserves; see Wehr 1994: هذا خرجك 'that's what you need, what you deserve') *relates to liability*, i.e. the risk of potential loss for which the person is responsible (from the root ضمن *damina*, 'to be or become responsible or liable, give security or guaranty').

Thus, another notion of 'fortune', different from, while complementary to, رزق *rizq*, '(God's) sustenance', appears here: that is to say, the basic postulate in Islamic finance that any legitimate profit (*kharaj*) has to derive from a liability, a responsibility, or an accountability (*daman*) of the economic actor for assuming a risk, through which he deserves God's blessing (*rizq*) by following the right Path, *Shari'ah*.

At this point, before interpreting how the principle *al-kharaj bi-l-daman* affects risk management in Islamic finance, a more in-depth investigation is needed with regard to Muslim anthropology. In my opinion, in fact, instead of looking at Islamic finance in the light of (conventional?) ethical investments, a more appropriate understanding of its logic can be derived from locating its rationales within the Qur'anic Creator paradigm that shapes the life of every Muslim (Netton 1989; Cattelan 2010 and 2013a). Accordingly, the conceptualization of risk in Islamic finance may find better interpretation in connecting *rizq*, as 'God's sustenance', to what is deserved by the human being through becoming responsible for his action (*daman* as source of legitimate profit). In other

[6] The literature dealing with Islamic economics and finance today is enormous: see, for instance, Archer & Karim (2007); Ayub (2007); Chapra (1979; 1993); El-Gamal (2006); Hassan & Lewis (2007); Iqbal & Llewellyn (2002); Khan & Porzio (2010); Siddiqi (1976; 1983); Usmani (2000); Vogel & Hayes (1998); Warde (2000).

terms, how God provides for human existence and how man, by becoming responsible for his actions, deserves God's favour in Islam (Gimaret 1980)?

As is well-known, Islam means 'submission to God': a submission of the believer (*muslim*), which is complementary to God's absolute omnipotence. The great theologian and legal scholar al-Ghazali (d. 505/1111), in his doctrinal work *al-Iqtisad fi'l-I'tiqad* summarizes the nature of God's creativeness in the sentence: 'What He wills, is and what He does not will, is not' (quoted in Ormsby 1984, p. 192):

> 'This extends to the least, seemingly insignificant, occurrence: "… not even the casual glance of a spectator nor the stray thought in the mind come to be outside the sphere of His will". Will is also expressed by the term *mashi'ah*, "volition", and so it is that the word *shay'*, "thing", deriving from the same root, is sometimes glossed as "what has been willed [by God] to exist".' (*ibidem*)

God's perpetual creative power models all the reality ('To Him is due the primal origin of the heavens and earth. When He decreeth a matter, He saith only "Be," and it is': Q. II:117; see also Hoover 2004), as an element of His unquestionable perfection.[7] Indeed,

> 'There are eight names for God, among the canonical ninety-nine, which direct our attention to Allah as the source of all that is: *al-Badi'* (Absolute Cause), *al-Bari'* (Producer), *al-Khaliq* (Creator), *al-Mubdi'* (Beginner), *al-Muqtadir* (All-Determiner), *al-Musawwir* (Fashioner), *al-Qadir* (All-Powerful) and *al-Qahhar* (Dominator), each with various connotations of creating.' (Burrell 2008, p. 141)

God being the only Creator, the Muslim lives 'in surrender' to God's omnipotence, as an *agent* of the only *Actor*, participating in the creation by performing God's Will, within a conception of time where the divine immediate creation is inserted within the flow of contingent human agencies, and 'the world comes to be at the time when the eternal will stands in nexus with its coming-to-be' (Ghazali, as quoted in Ormsby 1984, p. 193; for the alternative conceptualization of freedom in Islam, see Watt 1985).

The complementary truths of God's omnipotence and human responsibility, with the corollary linkage between divine eternity and human history in the flow of time (conceived as an atomistic succession of instants, each created by God: in this regard, see the illuminating Böwering 1997), find their pivotal reconciliation through the Revelation of *Shari'ah* (literally, 'the road leading to water', the Way, the Path) (Q. XLV:18) (Calder 1978). In fact, in order to make human beings responsible for their actions and able to deserve His blessings, God has given the Qur'an,[8] lit. 'what is read', the 'recitation', and sent the Prophet as reminder of the Message ('Say: "Nothing will happen to us except what Allah has decreed for us: He is our Protector": and on Allah let the Believers put their trust': Q. IX:51).[9]

[7] Parallel texts in Q. III:47,59; VI:73; XVI:40; XXXVI:82; XL:68.

[8] 'The Qur'an as a whole… maintains human responsibility at the same time as it asserts divine omnipotence… In the end, then, the Qur'an simply holds fast to the complementary truths of God's omnipotence and man's responsibility.' (Bell 1970, pp. 150-152)

[9] This is in Islam the Way, the Guidance that expresses the decision by God intervening under the form of a communication concerning human actions; in this sense, according to Stelzer, 'divine law is a manifestation of the divine Word'. (2008, p. 169; see also Goldziher 1981)

There are no obstacles for the believer to seek the right Way, the true Guidance: ‘for the Muslim the whole religion itself is in a very real sense a synonym of God’s guidance: Islam is “being rightly guided”’ (Netton 1989, pp. 24-25). The Revelation is clear and the clarity of Truth doesn’t require any imposition: ‘Let there be no compulsion in religion: Truth stands out clear from Error: whoever rejects Evil and believes in Allah hath grasped the most trustworthy hand-hold, that never breaks. And Allah heareth and knoweth all things’ (Q. II:256).[10] Anyway, the clarity of the Truth does not mean that it is manifest, and *ilm al-fiqh* (literally ‘science of comprehension’, ‘understanding’) is the discipline specifically aimed at making manifest God’s Will as clearly revealed in the Qur’an and exemplified by the Prophet (*sunna*).

To summarize the anthropology of Islam, as depicted by Netton in the Qur’anic Creator Paradigm, Muslim conception of life ‘embraces a God who (1) creates *ex nihilo*; (2) acts definitely in historical time; (3) guides His people in such time [through *Shari‘ah*]; and (4) can in some way be known indirectly by His creation [in the light of the understanding of the Revelation through *fiqh*]’ (1989, p. 22).

Indeed, in the total sovereignty by God to create everything that comes-to-exist, the ‘real’ itself (*haqq*, which is one of the name of God: *al-Haqq*) holds a meaning of ‘Truth’ as being ‘right’: in other terms, it fosters a conception of the reality as being essentially ethical, a product of God’s Will in the unity (*tawhid*) of the creation as the only (real, true, just) ‘Actor’, of which the believers are ‘agents’.

> ‘A vision of the reality as being in its essence imperative, a structure not of objects but of wills. The moral and the ontological change places, at least from our point of view. […] The “real” here is deeply moralized, active, demanding real, not a neutral, metaphysical “being”, merely sitting there awaiting observation and reflection; a real of prophets not of philosophers.’ (Geertz 1983, pp. 177-178)

Thus, the ‘right’ ontologically acquires a ‘tangible’, ‘real’ nature (not by chance ‘reality’ is one of the various meaning of *haqq* (pl. *huquq*), next to ‘truth’ and ‘right’: Lane 1865), as a ‘concrete’ entity whose allocation is provided by God (through the benevolence of His blessing, رزق), in the light of *Shari‘ah*: and, coherently, it is the performance of *Shari‘ah* that makes the human being responsible (*damin*) for his actions, thus deserving what is due (*kharaj*).

Coming back now to our topic of discussion, to which extent does this ontological nature of the ‘right’ affect the idea of risk and the practice of risk management?

Indeed, in a reality where everything is an immediate divine creation and the ‘right’ (*haqq*) subsists within the performance of *Shari‘ah*, if the future remains an (economic) opportunity, it is *not* anymore a ‘human product’ but the result of the human *participation* in the divine creation of the ‘real’ as an *agent* of the only ‘Actor’. It is this dual canon of ‘participation’ and ‘agency’ that logically implies in Islamic finance a conceptualization of risk that tends towards the primacy of the real economy over finance, exchange equilibrium, as well as risk-sharing strategies in financial dealings.

[10] ‘The truth is *clear*, *settled*, and *definitely convincing*… The truth stands here, facing us; it is *presented* to us. The truth in its completeness is submitted to us as clarity-for-us… The truth, established and secured by its certainty, makes no distinction between “momentary” and “eternal”. The truth is valid not because it has ascended above the nonlasting; the truth is valid because it stands firmly established amid the flow of things nonlasting.’ (Smirnov 1996, p. 338)

In a nutshell, paraphrasing Bernstein, the actions we dare to take, which depend on how responsible we are in performing *Shari'ah* in the reality created by God, are what the story of risk in Islamic finance is all about.

3. Conceiving and managing risk in God's creation: the logic of Islamic finance

As just remarked, in Islamic finance, according to the principle *al-kharaj bi-l-daman*, risk management is conceptualized as a distribution of gains and liabilities where the deserved profit (*kharaj*) follows the assumption of responsibility (*daman*) in the light of man's *participation* in the marketplace as an *agent* in the 'real'/'right' (*haqq*) created by God.

Here, the 'right' (*haqq*) necessarily relates to something 'real' (*haqq*, again); thus, any advantage or disadvantage cannot be separated from the actual possession or ownership of an underlying asset. Coherently, in Islamic finance risk management is shaped in the light of the primacy of the real economy, and asset-backed transactions substitute the nominal exchanges of conventional finance. In a nutshell, risk becomes in Islamic finance an asset-related 'entity', and not a commercial 'entity' *per se*, to the extent to which 'pure' financial products, such as derivatives, deemed lacking in any commercial value (since nothing 'real' is actually traded) are rejected.

This alternative conceptualization of risk may find further explanation within Islam's atomistic conception of time (Böwering 1997),[11] where God's creativeness shapes any instant in the unity (*tawhid*) of the 'real'/'right' (*haqq* as result of the only Truth, *Haqq*). At the micro level of human existence, this cosmology (Netton 1989) is mirrored by a *haqq* that is not conceived anymore as the 'right' of a person in opposition to the 'right' of another person, but as a logical structure comprising both the 'right' and its corresponding 'obligation' (Kamali 1993), which makes sense 'only within the *unity* of the two "elements" […] the *huquq* are not the "rights" and "obligations" that serve to connect autonomous elements' (Smirnov 1996, p. 345), but 'sides' of a justice existing through a balanced unity (*tawhid*), where economic resources are 'shares' of the unique justice ('*adl*) given by God (from which, possibly, the concept of 'sustenance', رزق). Then, if time is composed of single instants created by God, *each* of them must hold a balanced distribution of 'rights' (*huquq*), ruled by a transactional equilibrium, which is guaranteed by quantitative balance (prohibition of *riba*) and qualitative disclosure (*gharar* and *maysir*; Cattelan 2009). Debt-structures and hazard-affected transactions (as in the case of financial derivatives), therefore, become unlawful in the light of Islamic risk management.

Last, as seen, this asset-backed financial model, fostered by the need of exchange equilibrium, upholds human agency and participation in the 'real'/'right' (*haqq*) through

[11] Thus, 'atomism was not only most congenial to a vision of God acting instantaneously in the world as the sole true cause, it also proved akin to Arabic grammar, which lacks genuine verbs for "to be" and "to become". Neither does Arabic employ the tenses of past, present, and future. Instead, it uses verbal aspects of complete and incomplete, marking the degree to which an action has been realized or is yet to be realized without distinguishing precisely between present and future.' (Böwering 1997, p. 60)

criteria of profit-loss sharing implemented by Islamic financial institutions in their business activity.[12]

Considering all this, some conclusions can be advanced on the conceptualization of risk (as *rizq* رزق and, then, *daman* ضمن) in Islamic finance.

A fundamental principle has been preliminarily mentioned in our investigation: *al-kharaj bi-l-daman*, 'profit follows responsibility', *ubi emolumentum ibi onus.* The principle is incorporated in a famous *hadith*, according to which the risk for loss of an asset falls upon the person who is receiving benefit from the asset itself.[13] As seen, in Islamic finance any advantage or disadvantage cannot be separated from a contextual ownership or possession (gain accompanies liability for loss).

Thus, in case of commercial activities, where participants provide capital and/or labour, the contracting parties necessarily *share* the risk of the undertaking, and, consequently, its profits (*mudaraba* and *musharaka*). In asset-based transactions, risk follows the ownership or possession of the *res*, and a fixed return (e.g. the mark-up of *murabaha*) becomes admissible, not in terms of the illicit *riba*, but as related to the risk that has been borne by the vendor (again, *al-kharaj bi-l-daman*). In other terms, here, the risk is not a commercial 'entity' *per se*, but 'is generally a function of either legal ownership or possession of the *res*' (Fadel 2002, p. 83).

The proposed interpretation of *al-kharaj bi-l-daman* as the principle governing the legitimacy of profit in Islamic risk management finds confirmation in the centrality of the object in the theory of contracts in Islamic law (where 'it is the thing… that takes primacy. […] the thing must have a material, concrete existence. It does not exist trace of what has been called: *res incorporales*': Chehata 1973, p. 122; see also Vogel 2006). This principle provides hermeneutical help in the understanding of the *fatawa* issued by *Shari'ah* scholars in Islamic finance, as well as the recommendations by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).[14]

For instance, the principle *al-kharaj bi-l-daman* as 'risk linked to the *res'* finds a direct application in the definition of *sukuk*, *Shari'ah*-compliant investment certificates,[15] according to Art. 2 AAOIFI *Shari'ah* Standards. Here investment *sukuk* are defined as

> 'certificates of equal value representing *undivided shares* in *ownership* of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity' [italics not in the original text]

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[12] Although much is still to be done in the direction of equity-products, such as *mudaraba* and *musharaka*, as major share of their portfolio. Accordingly, Islamic scholarship has always called for an increase of equity-based products in the balance sheets of Islamic financial institutions. See, for instance, the resolution by the AAOIFI Shari'ah Board (13-14 Feb 2008, Bahrain): 'the *Shari'ah* Board advises Islamic Financial Institutions to decrease their involvement in debt-related operations and to increase true partnership based on profit and loss sharing in order to achieve the objectives of the *Shari'ah*'.

[13] *Abu Dawud, Tirmidhi, Nisa'I, ibn Maja, Ahmad ibn Hanbal.* The principle was also incorporated in Art. 85 of the Majalla (see also Art. 87, *al-ghurm bil-ghunum*, which has the same meaning).

[14] The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a non-for-profit organization established on 26th Feb 1990, aimed at proposing accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions and the industry (www.aaoifi.com): see, for instance, previous note 12.

[15] In the financial market a variety of *sukuk* are already known: investment *sukuk* are based on the contracts of *mudaraba* or *musharaka*; in the case of the sale or rent of the assets, other structures are applied (i.e. *sukuk al-murabaha* or *sukuk al-ijara*).

and, according to Art. 5/1/2,

> ‘it is permissible to issue certificates for (to securitize) assets that are tangible assets, usufruct and services by dividing them into equal shares and issuing certificates for their value. As for the debts owed as a liability, it is not permissible to securitize them for the purpose of trading.’

The reference to the ownership of *tangible* assets, usufruct and services as ‘source’ of legitimate profit for the *sukuk* holder is clearly related to the interpretation previously given of the principle *al-kharaj bi-l-daman*; the reference to ‘undivided shares’ finds justification in the undivided character of the reference pooling; the criteria of primacy of real economy, transactional equilibrium and profit-loss sharing clearly emerge as well.

The same principle has been confirmed in a resolution by the AAOIFI *Shari‘ah* Board (13-14 Feb 2008, Bahrain) on the issuance and trade of *sukuk*, which has brought about massive consequences on the market of Islamic securities, specifying that

> ‘*sukuk*, to be tradable, must be *owned* by *sukuk* holders, with all rights and obligations of *ownership*, in *real* assets, whether tangible, usufructs or services, capable of being owned and sold legally.’ [italics not in the original text]

The meaning of the ruling, with its reference to the ownership of the underlying assets, reflects a logic where commercial dealings are part of a ‘reality’ (*haqq*) created by God: accordingly, the ‘incorporation’ of the *risk* in *real* assets, through their ownership or possession, guarantees the balanced distribution of gains according to the responsibilities assumed by the parties (*al-kharaj bi-l-daman*).

At this point, one may say that risk does not exist in Islamic finance as ‘unbundled commodity’ the way it does in conventional finance: on the contrary, since ‘risk of loss is deemed to be a characteristic either of legal ownership or possession, [… it is] not deemed property that can be exchanged for other property’ (Fadel 2002, p. 83).

Thus, in Islamic finance, the risk is shared when capitals or workforce are put together (commercial enterprises), since it *belongs* to the capitals and workforce (*mudaraba* and *musharaka*); it is transferred in a sale (or in any other transaction, such as lease) since it *belongs* to the transferred property (*murabaha*, *salam* or *ijarah*).

With specific reference to the ban of ‘unreasonable uncertainty’, and in accordance with the reasoning followed in this paper, El-Gamal interprets the prohibition of *bay’ al-gharar* in the sense of the ban of the ‘trading of risk (of loss)’, as property *per se* (2001).

Consequently, a conventional insurance contract, where the risk of negative events is transferred from the beneficiary to the insurer with the contextual payment of a premium, is deemed invalid in Islamic finance, since the amounts exchanged by the insured and the insurer are unequal and depend upon uncertain future events. For these reasons, the insurance contract is replaced in Islamic finance by the *takaful* company, where, on the contrary, the risk is *shared* among the participants in a mutual guarantee linked to an investments fund, which may be structured as *mudaraba* or *musharaka* or according to a *wakala* (agency) contract related to the administration of the fund. Once again, the criteria of primacy of real economy, exchange equilibrium and profit-loss sharing dominate Islamic risk management.

In this context, an example of this alternative conceptualization is given below, with regard to the invalidity of a conventional insurance contract:

> 'Take an insurance contract. At T_1, A, the insured, pays a premium to B, the insurer, in exchange for B's promise to protect A against certain losses should a predetermined contingency occur. A pays a *thaman* in the form of premiums but does not receive a *muthamman*, at least not immediately, in return. Likewise, B receives a *muthamman* but does not immediately deliver a *thaman* to A. After the parties enter into the insurance contract, one of the two scenarios is possible.
>
> In the first scenario, the specified contingency occurs and B compensates A for the loss. From the perspective of the jurists, the money delivered from B to A is A's *muthamman* that he receives in exchange for the premiums that he had already paid. Similarly, the money B pays A in this scenario is the *thaman* that B paid in order to receive A's *muthamman* (premiums). Accordingly, they conclude that this exchange is invalid: first, because it involves *riba* (the deferred exchange of money); and second, because of uncertainty in the *thaman* and the *muthamman*. Recall that the promise to indemnify against a loss cannot serve as the *muthamman* that would complete the exchange because it is not property that can be delivered to the insured.
>
> In the second scenario, the term of the insurance contract is completed without the occurrence of the specified contingency. In this case, according to the jurists, there simply has been no exchange: although the insured has delivered property to the insurer in the form of premiums, the insured has never delivered any property (*muthamman*) to the insured in return. Likewise, the insurer has received property (*muthamman*) without paying a price (*thaman*) in exchange. Accordingly, the trade fails because it entails "consuming the property of another unjustly" (*akl amwal al-nas bi-al-batil*)". In the view of the jurists, it is unjust for the insurer to keep the property of the insured without ever giving him property in return.' (Fadel 2002, p. 83)

4. Conclusions: another, remarkable, story of risk?

Sailing (metaphorically) the Mediterranean from its Western to the Arab side, in search for firm land (the Greek *ριζα*) to avoid the perils of the sea, this paper has moved from the Western risk to the Arabic *rizq* رزق, in the attempt to provide an interpretation of risk management within the distinctive anthropology of Islamic finance.

In this direction, it has been suggested that in order to look at the hazard of the future, زهر *zahr*, the 'dice' of human chances, through an inter-cultural approach, Bernstein's *Remarkable story of risk* should be read not 'against', but 'in the Name of God'. Indeed, in an anthropology of time where not only the future, but also the present, is a divine (rather than human) creation, the conception of risk is re-framed at its very roots, leading to criteria of risk management that cannot leave aside the 'real'/'right' (*haqq*) of God's (*Haqq*) creation. Thus, primacy of real economy, exchange equilibrium and the pursuit of profit-loss sharing become the cornerstone of any legitimate human profit (*kharaj*) as a result of an assumption of liability (*daman*); and the paradigm of banking, insurance and investment activities, necessarily framed in the light of asset-backed and commercial enterprises, becomes hardly comparable to the conventional one.

Of course, the voyage from the Western risk to the Arabic *rizq* رزق, and then *daman* ضمن as human responsibility for performing *Shari'ah* as source of legitimate profit (خرج *kharaj*), has been roughly 'mapped' in these pages, and rapidly sketched: much further investigation is needed for a comparative history of risk, according to an inter-cultural perspective. But, to the extent to which this paper may represent a little contribution to the matter, two final considerations are advanced, both with regard to the Western and Islamic theories of risk management, and to their current co-existence in the international financial market.

First, looking at both sides of the Mediterranean, another protagonist, next to risk, should be considered for a comprehensive, comparative financial theory: the idea of 'credit', and credit management. In this regard, if in Bernstein's *Against the gods* the role of Christian thought in the history of risk is marginalized, the great cultural historian Jacques Le Goff, in contrast, has highlighted how religion must not be forgotten when writing the history of money and credit in Western society (Le Goff 1986 and 2010): in this way, in the 'fight' between gods and men for ruling the (un)expected, the former get their own back. On the Arab side, if Brunschvig underlines how in classical Islamic thought "like any good and useful good, gold (*dhahab*) and silver (*fidda*, *wariq*) have been created and given generously by God to the disposition of the human being" (1976, p. 273) (and here, indirectly, *rizq* رزق reappears again), much has still to be investigated on the conception of money and credit relations (*dayn*) in Islamic finance. Metaphorically speaking, another voyage through the Mediterranean is certainly needed.

Second, if an alternative conceptualization of risk characterizes Islamic finance, as this paper has tried to highlight, it seems to me that further consideration should be given to this diverse, while still remarkable, story of risk in financial regulation, too. In fact, while a plural financial system, where different conceptions of economic justice(s) co-exist and influence each other (Cattelan 2013), may still be distant, it cannot be denied that a level playing field, where conventional and Islamic finance will be able to co-exist and prosper in the same marketplace, will necessarily have to consider how parameters of capital adequacy and governance for Islamic financial institutions should be adapted in the light of their peculiar model of risk management, requiring amendments *ad hoc* to international standards (e.g. Basel criteria). These adaptations, far from certifying 'god's victory' over the human story of risk, will foster a fair competition in a marketplace where Islamic and conventional finance will properly integrate one aside the other, under the same (God's) sky.

In the end, if on the one side the remarkable story of risk leads our rationality as well as imagination to deal with the (un)expected, between gods' and men's power, and in this way "helps define what it means to be a human being" and "how free we are to make choices" (Bernstein 1996, p. 8), on the other side a comparative study of risk in financial theory may lead "to alternative perspectives on economic development and social integration, nourishing […] an open society through the centrality of individual freedom" (Cattelan 2013b, p. 232).

And this freedom to choose among alternative financial models may be what the future story of risk will be about.

Transliteration note

Please consider that in the transliteration from Arabic into English, graphical forms have been simplified (e.g. *riba* instead of *ribā*; *Shari'ah* in the place of *šarī'ah*; *daman* instead of *ḍamān*; *haqq* in the place of *ḥaqq*; and so on). I am confident that the stylistic choice to simplify the text (while making it, undoubtedly, imprecise) will not deprive the Arabic reader from an immediate understanding of the Arabic terminology, to the extent to which it helps making the writing less intricate for a non-Arab audience.

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