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Risk-sharing in Finance: The Islamic Finance Alternative
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Risk-sharing in Finance is the latest joint work of Hossein Askari, Zamir Iqbal, Noureddine Krichene, and Abbas Mirakhor in which they present Islamic finance as an alternative to debt-based risk-shifting conventional finance. The authors have common characteristics of holding experience of work at the world organizations, IMF and World Bank, skills in conventional finance and academic interests. Islamic finance is their favorite subject in which they have deep insight. They have authored several scholarly works on its various aspects, individually or jointly with different authors.

The book highlights characteristics, operations, and benefits of a comprehensive risk-sharing financial system for long term economic and social prosperity. The risk-sharing has been defined as ‘a contractual or social arrangement whereby the outcome of a random event is borne collectively by a group of individuals or entities involved in a contract, or by individuals or entities in a community’ (pp.70-71). Risk-sharing is an essential feature of equity financing, where the risk of loss and gain are shared by the partners. Such a system provides impetus to economic growth because the financial sector and the real sector are seen as closely linked, with both having to grow in tandem. It also results in social gains

in two forms - more interaction between investors and entrepreneurs bringing the parties closer, and steady economic and employment growth that would avoid social upheavals. However, the authors feel that "modern Islamic finance has not been developed on a solid Islamic foundation with a necessary scaffolding to enable its adoption as a complete financial system in a country or region". So their aim in this book, in their own words, is to present "development of Islamic finance as a comprehensive financial system that could be adopted without difficulty."

The book is divided into three parts consisting twelve chapters in total in addition to preface and glossary of Arabic terms in the beginning.

Part One gives a brief account of the history of financial crises, their causes, an overview of theories put forward to explain them and how they may be eliminated or minimized. It also deals with a phenomenon in the contemporary debt-based economy, termed as "financial decoupling" or "financialization". The authors argue that the conventional system is inherently unstable, often shaken by periodic crises and requiring massive bailouts, because it is pre-eminently a debt and interest-based system, and it creates excessive debt and leveraging through the credit multiplier. Thus, debt and fixed rate of interest has been the root cause of financial crises in the past and at the present, and it is most likely to be a cause of financial crisis in future if it persists. In such a situation, the growth of pure financial instruments outstrips the real sector as they have little connection to real assets. In the interest-based financing, where the lender does not share in the risk of losses, all the risk of loss is shifted to the borrower. The authors demonstrate that "a system based on risk-sharing and equity finance is immune to instability; and that such a system requires no bailouts and does not lead to social injustices, such as privatizing gains and socializing losses", that plague the conventional financial system (p. 3).

In order to fit into their proposed framework, the authors view financial intermediation and banking in Islamic financial system as a two-tier banking system. One kind of account will be where people deposit money for safe keeping without expecting any return. For such accounts the banks have to keep 100 percent cash reserves. The banks will not expand credits on the basis of those deposits. This will save them from a deposit guarantee. In this way, Islamic system overcomes

classical asset-liability mismatch problem. Another type of account will be for those who want to share in profit and loss. Deposits in this account are considered as equity investments and will have no guarantees of their face value at maturity. The depositors will share in profits and losses. Thus, in Islamic system credit cannot expand or contract independently of the real sector. The authors support their stand by Chicago Plan of 1933 that called for 100 percent reserve on deposits and prohibition of credit creation by the commercial banks, money issue being monopoly of the Government.

It may be noted that the issue of fractional reserves and credit creation has been a controversial issue among Islamic economists. Excess liquidity and its management is one of the problems that Islamic banks are facing. The provision of 100 percent reserves will aggravate the problem of excess liquidity. Since people are in the habit of withdrawing a small amount of their deposit at a time, a huge amount will always be lying idle with the banks. Would it not be feasible to use this amount for meeting very short-term finance needs of productive sector or for micro financing on the basis of *qarḍ ḥasan* or through contracts like *murābaḥah*, *salam*, etc.? In the opinion of this reviewer the issue needs further debate.

Part two presents an overview of the history of risk-sharing finance in Islamic system as well as in the conventional system. It also deals with the risk-sharing and the Islamic finance paradigm. It examines the balance between short-term, less risky, liquid assets and long term, higher risk, and illiquid assets and emphasizes the role of vibrant stock markets for the success of risk-sharing and equity finance. The authors consider "the stock markets as a fundamental driver of Islamic finance". They examine the question "how money markets and capital markets could promote risk-sharing." They also review portfolio theory and asset pricing, and complementary role of intermediaries in promoting risk-sharing. This part of the book reviews the theoretical basis of risk-sharing and the role of securities in the allocation of risk. It presents the model and various empirical findings about risk-sharing in consumption. The chapters in this part are meant to support authors' presentation of risk-sharing in finance as the Islamic alternative for the conventional debt dominated risk-shifting finance.

As the empirical studies have shown, even Islamic financial institutions have made increasing use of those contracts which are in the nature of debt financing such as *murābaḥah* and *ijārah*. Asymmetric information has been the main cause behind such a trend. The authors think that information technology advances, will mitigate the informational problems and lead to less reliance on debt-based contracts.

According to the authors there would be two types of capital markets in an Islamic system – the market for equities, and for securitized 'asset-linked' certificates representing ownership in a pool of assets. Once the assets are securitized and a financial security is created, such securities can be traded on organized capital markets, primary or secondary. The main difference between conventional securitization and the Islamic asset-linked security is that "whereas in the conventional system there may be multiple layers of ownership, in the Islamic system there is strict requirement of clear ownership rights for the investors" (p.170). The authors claim that "this feature, in contrast to the conventional system, affords greater stability as the same underlying asset is not traded many times over, which could have a cascading effect in the case of liquidation. More importantly, in conventional securitization the underlying assets are debt-based, and thus have an implicit guarantee of the principal, whereas securitization in Islamic system is based on risk-sharing" (pp.170-71).

In the authors' opinions, "development of a secondary market is important and essential to the development of a primary market."… (p.172). However, it cannot be denied that existence of both markets is necessary and is vital for efficient financial intermediation, which could play an imperative role in risk-sharing financial structure.

The authors accept that, "In an Islamic system, perhaps more than in any other, both the primary and secondary markets require active support of the government and the central bank, not only in their initial development and promotion but also in their supervision and control, in order to ensure their compliance with the rules of the Sharīʻah" (p.173). To foster the development of Islamic finance, the authors reiterate, "There is need to emphasize its risk-sharing foundation, remove biases against equity finance, reduce the transaction costs of stock market participation, create a market-based incentive structure to minimize

speculative behavior and develop long term financing instruments as well as low cost efficient secondary markets for trading equity shares" (p.92).

After discussing, in part two, the essentials of risk-sharing and the prohibition of debt and establishment of vibrant capital market as complementary institutional requirement for its success and after having dealt with its characteristics such as asset pricing, and portfolio properties, intermediation, and stability, the authors turn in part three to deal with a major theme of the book, that is, to answer "what are the necessary developments and steps before the Islamic financial system can be established and practiced in a country?"

Thus, in part three the authors assess the needed elements to establish a complete Islamic financial system in a country. Part three also deals with the enhanced access of finance, social welfare, and economic development under the risk-sharing system. The authors stress upon the need for "creation of financial and economic institutions that are based on and governed by Islamic teachings on economics, finance, and appropriate human behavior in business and financial dealings". They also discuss "the required governance principles for developing economic institutions" (p.202). But they realize several gaps between the theory and practices of Islamic finance, especially among the Muslim countries. They devote a full chapter – Chapter Eleven - to deal with such gaps.

One important aspect of the book is its emphasis on the use of *qarḍ ḥasan* as helping the poor to have access to microfinance. But the institution is not fully utilized. It can play an important role if the required institutional structures are developed (p.199).

According to the authors, in the conventional finance the sole enforcement mechanism of ethical behavior is market discipline. Since "the Islamic financial system derives its values from the teachings of Islam' it is expected from the leaders, managers, and other stakeholders to follow the rules prescribed by the Sharīʻah" (p.222). However, due to human weaknesses and with its many shortfalls, "efficient institutions, especially the rule of law and all that it entails, are prerequisite to success; and this must be accompanied by governance structure that truly reflects Islamic values and effective enforcement" (p. 223). Perhaps this realization was behind the saying of the third caliph of Islam: "Allah

checks things by power which are not checked by the Qurãn", i.e., by preaching and persuasion.

In the past few years, Islamic finance has become a global movement, yet there exist gaps between theory and practice of Islamic finance in Muslim countries. The authors admit this and examine the key divergences in this respect (p.226). For example, on "Islamicity index" Muslim countries have very low ranking; they are generally reluctant to promote risk-sharing finance; and there is paradigm gap between what Islam teaches and actual behavior in the market. But the authors do not answer why it is so; why even on "Islamicity index" non-Islamic countries are far ahead of Muslim countries who are followers of the Prophet who came to complete the noble ethics. Perhaps, the authors avoid this debate as it will take them to a new discussion.

However, the authors argue that, "If and when such a sharing-system is established, the first country where it would be established is likely to be a Muslim country" (p.255). This is in contradiction to their earlier remark on page 67 that "legal and institutional developments, along with good governance and adoption of standards of best practice in transparency and accountability at the level of individuals, firms, and the state, will boost equity participations and contracts based on risk-sharing, "*not only in Islamic countries, but the world over*" (p.67, emphasis added). At the same time they are not very optimistic of its realization in Muslim countries as their moral, political and economic conditions are not very conducive to promote such a system. "Muslim countries, on the whole, score quite low on the social and economic values, and achievements that they should exhibit" (p.255). The question then is, "why a Muslim country?" Why cannot any country, that fulfills the pre-requisites of risk-sharing finance, benefit from the system, to the extent it fulfills them? After all risk-sharing finance is not an invention of Islam; it was followed in pre-Islamic Arabia; it was practiced in medieval Europe; and it is still not absent altogether from the existing Western and conventional system. Due to the difficulties through which the world in general and the West in particular passed during the recent financial crises, there is search on the part of the world for an alternative system immune to frequent crises. The authors argue that the risk-sharing finance will promote "financial access, enhance economic growth, provide more jobs, reduce government waste, and better protect the interest of future generations" (p.256). Are these objectives not valuable

for contemporary economy? The need of the hour is to present risk-sharing in finance as a just system for use around the world by providing a helpful paradigm for crafting global financial reforms, and convince the sincere decision makers in every country to adopt and promote it and discourage the institutions based on risk-shifting, the root cause of financial crises. In the opinion of this reviewer, this is the message that one gets from appreciations of this work by two Nobel Laureates - George Akerlof and Robert C. Merton – noted inside the cover page of the book.

The book is well documented. However, the authors do not refer to the source for their statement that "In the late 19th century, a formal critique and opposition to the element of interest started in Egypt when Barclays Bank was established in Cairo to raise funds for the construction of Suez Canal" (p.59). As a student of the history of Islamic economics and thought, this reviewer wishes to know its details. As far as Suez Canal is concerned, sources state that its excavation began on April 25th, 1859, and was completed on November 17, 1869. A company known as 'La Companie Universelle du Canal Maritime de Suez' was formed in 1858 to manage finance and control the project. No doubt, ever since Muslims came across Western banking, they had reservation about interest payment. Most of them considered it illegitimate (*ribā*) but it needs a documentary proof to say that "a formal critique and opposition to the element of interest" started in Egypt in the late 19th century.

Similarly, the authors' statement that 'a formal opposition to the institution of interest can be found as early as 1903 when the payment of interest on post office saving funds was declared contrary to Islamic values, and therefore illegal, by Sharī'ah scholars in Egypt' (p.59) needs reference to an authentic source. The relevant sources state that some 3000 depositors in the post offices did not withdraw the extra amount over their deposits considering it *riba* (interest). The authority sought the solution. The Azharite '*ulama'*, including Muhammad Abduh, the then Grand mufti, suggested that the deposits should be invested on the basis of *muḍārabah*. From this story, no doubt, it is clear that Azhari '*ulama'* also considered interest as *ribā*, but should we call it as declaration of "a formal opposition to the institution of interest?" Perhaps, a search for the original source may eliminate the apparent contradiction regarding the period mentioned in the two stories narrated above about "a formal opposition" to interest. As a whole the reference section of the book is

very rich. It provides about 400 sources which is a wealth of literature for any researcher on the present topic.

Utmost care should have been taken while copying/translating the Qurãnic verse quoted on p.83: "Those who devour usury will [not] stand except as one who [whom] the Evil one by his touch hath driven to madness (2:275). In the above translation the word 'not' is dropped, and 'whom' has been written as 'who'. On p.68, footnote 1, the word *"al-ṣadaqāt"* (in the Qurãnic verse 2:276), has been translated as 'deeds of sharing'. It should be 'deeds of charity'.

The glossary part of the book is very useful for the readers. However, it would have been useful if the Arabic terms in the book were transliterated, which has not been done. Furthermore, it is marred by many errors in spellings of these terms. Here are a few examples: Alnas [*al-nas*], al-Mo'meneen [*al-Mu'minin*], bai' bithamin [*bay' bi thaman*], dharoora [*darurah*], ghaban [*ghubn*], hadia/hibah [retaining 'h' in *hibah* while dropping in hadia [*hadiah*]. Similarly 'ibada and ijarah [ending 'h' retained in *ijarah*], ijarah wa "qtinah" [*ijarah wa iqtina*, it is wrong to write 'h' at the end], khisarah [*khasarah*], wikalah [*wakalah*], kifalah [*kafalah*], tijaarah/tijrajah [*tijarah*], salaam [*salam*] p.103, etc.; *qard hasan* has been written in various ways - *qard-ul-hassan* (pp.194-96), *qard-e hasan* (p.225), *qard hasan* (p.237). The correct is *al-qard al-hasan* or simply *qard hasan*. There is need to take more care in transliteration; a uniform scheme should be followed, throughout the work which is unfortunately not the case in this work. A few typographical errors may also be pointed out that should be corrected in a later edition of the work: qtinah [*iqtina*`] p.xxi; tijrajah [*tijarah*] p.xxiii; contacts [contracts] p.55; amanna [*amanah*] p.102; Khums [*khumus*] p.211; Yes [Yet] p.226. Iqbal, Zubair [Iqbal, Zamir] p.287.

In the end I must reiterate that the book offers interesting reading for those who have interest in Islamic finance. It is an addition to the literature on the subject.