Islamic Finance, Risk-Sharing, and International Financial Stability
by Hossein Askari

In the aftermath of the financial crisis of 2007–2008, the fundamental stability of the conventional financial system has been seriously questioned. Excessive leveraging, combined with an inherent asset-liability mismatch, exposes institutions to unsupportable risk, and threatens the overall soundness of the financial system. An alternative to the current model is one traditionally advocated by Islam and other Abrahamic religions. Islamic finance eliminates debt financing and instead promotes equity or direct asset financing, which allows for risk-sharing instead of risk-shifting. Financial institutions serve their traditional role as intermediaries between savers and investors, but with no debt on their balance sheets, eliminating the potential for excessive risk. The stability of the international financial system would be enhanced if reliance on debt were reduced: the global financial system would rely more heavily on risk-sharing, equity finance, and genuine asset securitization, linking the payoffs of financial securities to the underlying assets that are financed.

Introduction

In an era of rapid globalization with high capital mobility, financial instability and its contagion effects have become major concerns for policymakers around the world. Although countries have traditionally focused on trade liberalization as an opportunity for global economic cooperation, the aftermath of the ongoing global financial crisis that began in 2007 and the current European sovereign debt crisis challenge the sustainability of international finance. The severe economic contractions resulting...
from these two financial crises have dwarfed all precedents of cross-border economic shock since World War II. As financial crises take an ever-larger international toll, sovereignty over national finances is increasingly tested, with countries demanding an important say in the financial regulation and budgetary policies of other countries. The main culprit behind many of these financial crises has been the assumption of excessive debt and leveraging. In order to avoid these problems in the future, it is necessary to reform the financial system. A system resembling Islamic finance would preclude the assumption of excessive risk by prohibiting debt and risk-shifting in favor of risk-sharing and equity finance; a significant reduction in debt financing would go a long way to stabilize international finance. Such a system is inherently more stable, with variations of it advocated by noted economists including Irving Fisher and Milton Friedman.

The Fundamental Instability of the Conventional System: Debt and Leveraging

The causes of the US financial crisis are manifold. Defined by wholesale deregulation and inadequate supervision, the conventional financial system allowed individuals and firms to assume excessive levels of debt and risk. An extended episode of low interest rates also encouraged excessive risk-taking, with inadequate capital requirements for banks and other non-bank financial institutions. Furthermore, the emergence of a shadow banking sector (the repo market), opaque financial innovations, mark-to-market accounting, the shortcomings of credit rating agencies and fraud, all contributed to the crisis. Unfortunately, the rest of the world was not insulated from the crisis in the United States; cross-border capital mobility and dense international interdependence caused the crisis to rapidly spread to markets around the globe. Ultimately, debt and leveraging are the main sources of financial instability in the current system. In the absence of debt, institutions would not have been leveraged: losses from bad investments and bankruptcies would have been contained to affected investors and their own capital contributions.

In the euro crisis, the trade-off for replacing multiple currencies with a single currency became apparent, as the changing competitiveness of countries could no longer be balanced through exchange rate adjustments. Countries like Greece and Portugal borrowed and lived beyond their means because lenders wrongly assumed that these countries were backed by Eurozone credit. Others, such as Italy and Spain, had manageable levels of public debt, but were contaminated by Greek insolvency. Suggested reforms have focused on strict rules to limit public sector deficits, consolidate fiscal regimes, and expand the role of the European Central Bank (ECB). Strict rules on public sector deficits would reduce inflationary pressures, moderate the loss in international competitiveness and decrease the spread of a country’s borrowing cost over that of
Germany’s. The consolidation of fiscal regimes, namely through the issuance of euro bonds, would eliminate borrowing spreads. A change in the articles establishing the ECB to act as a Lender of Last Resort would also eliminate higher spreads for deficit countries. Despite the potential success of these proposed reforms, it is crucial to recognize that at the heart of the euro crisis—similar to the problems faced by the United States—is the assumption of excessive debt and leveraging, which has lead to increased divergence in national production costs and competitiveness.

Conventional banking is based on a fractional reserve system that creates money and encourages borrowing and leveraging. Combined with asset-liability mismatch, the inherent risk of such a system is that leveraging becomes excessive, threatening the stability of financial institutions. Implicit government safeguards like deposit guarantee schemes (such as FDIC insurance in the United States) and the classification of some banks as “too big to fail” further perpetuate unrestrained risk-taking by reducing funding costs and creating moral hazard. To enhance financial stability, regulators would have to adopt policies and practices that eliminate moral hazard, excessive debt creation, and leveraging. The quest for financial stability will require a reduction in risk-shifting, debt financing, and leveraging, in favor of expansion in risk-sharing and equity finance as explained in the following section.

The Quest for Financial Stability: Risk-Sharing and Equity Finance

One way to ensure the stability of the financial system is to eliminate the asset-liability risk that threatens the solvency of all financial institutions, including commercial banks. This requires commercial banks to restrict their mandates to two activities: (i) cash safekeeping, and (ii) investing client money in a mutual fund. Banks could accept deposits for safekeeping only (i.e., adopt a hundred percent reserve requirement), and charge a fee for providing this service and for check-writing privileges. In their intermediation capacity, banks would identify and analyze investment opportunities and would offer them to clients; the bank would charge a fee for these services as well, much like a traditional investment bank does today. A commercial bank or a non-bank financial institution would not assume any asset-liability risk on its balance sheet. Instead, gains or losses would accrue directly to client investors. An institution, however, could also invest its own equity capital in the client’s investment projects as well as other projects independent of the client. In this case, the financial institution would not be assuming any asset-liability exposure, just a potential loss of a fraction of its capital, which would not endanger its solvency. Moreover, in the absence of debt and leverage, financial failure is localized and prevented from infecting the entire financial system. This is because an institution that only operates with contributed capital and fees from mutual fund activities does not endanger other institutions if its
investments fail. In the case that investments do go sour, the institution would lose some of its capital and its mutual fund investors would lose their investments. But because the bank did not borrow, it could not lose multiples of its capital, and thus endanger the solvency of other institutions. These safeguards are the basic tenets of Islamic banking and finance.

Proposals for commercial banking along these lines are not new. Such a reform was recommended in the ‘Chicago Plan,’ formulated in 1933 by a group of University of Chicago professors, including Henry Simons, Frank Knight, and Paul Douglas. The Chicago Plan was also strongly supported by Yale University professor Irving Fisher, arguably the most renowned American economist of his time.¹ Noting the fundamental monetary cause underlying each of the severe financial crises in 1837, 1873, 1907 and 1929–1934, the Chicago Plan called for a full government monopoly in the issuance of currency. This barred banks from creating any money (demand deposits) or “near money” such as saving deposit accounts, which could be readily turned into cash, by establishing hundred percent reserves against checking deposits. Investment banks that play the role of brokers between savers and borrowers were to undertake financial intermediation. Hence, the inverted credit pyramid, the highly-leveraged financial institutions (e.g., hedge funds), and monetization of credit instruments (e.g., securitization) are excluded. The credit multiplier is far smaller, and is determined by the savings ratio instead of the reserves ratio.

As stated by Irving Fisher:

The essence of the 100% plan is to make money independent of loans; that is to divorce the process of creating and destroying money from the business of banking. A purely incidental result would be to make banking safer and more profitable; but by far the most important result would be the prevention of great booms and depressions by ending chronic inflations and deflations which have ever been the great economic curse of mankind and which have sprung largely from banking.²

Milton Friedman also endorsed this plan. More recent than the Chicago Plan, Laurence Kotlikoff has made a proposal along similar lines, coining his approach Limited Purpose Banking (LPB).³

Before the rise of debt financing, equity financing was pre-eminent. While risk-sharing techniques continued to prevail in Europe until the mid-seventeenth century, the institution of interest-based debt financing spread widely in the mid-sixteenth century. The emerging dominance of this method of financing was due to a number of factors. The most important of which was the general breakdown of trust in Europe. Risk-sharing finance is trust-intensive, and trade financing during the Middle Ages was based on risk-sharing. Recent research indicates that catastrophic and traumatic experience contributes to the breakdown of trust in a community and among its members. The Middle Ages certainly witnessed enormous, continuous, and extensive traumas, including four crusades, three Mongol invasions, and numerous wars in Europe. In addition, the Bubonic plague of the mid-fifteenth century spread rapidly throughout the then-known world along well established and intensively traveled trade routes.⁴
As a result of these circumstances, interest-based debt financing came to replace equity financing as the principle means of borrowing in Europe.

Government deposit insurance, tax treatments, and banking rules and regulations also heavily favored debt-based contracts over risk-sharing contracts. These developments perpetuated a system that John Maynard Keynes deemed detrimental to economic growth, equitable income, and wealth distribution. More recently, a growing literature of proposed reforms have argued that the stability of the financial system can only be assured by limiting debt creation. This requires governments to eliminate implicit and explicit subsidies that fuel moral hazard, and limit—or in the case of Islamic finance, prohibit—the creation of money through the fractional reserve conventional banking system.

The Islamic Financial System: A Risk-Sharing Model

While a number of noted economists have advocated a financial system that limits debt creation, Islamic finance addresses the problem by replacing debt with equity finance. In essence, Islamic finance is a financial system structured on risk-sharing and the prohibition of debt financing. Islamic finance prohibits transactions that charge rents (i.e., interest) as a percentage of principal without the transfer of the property rights to the lender. For example, if a bond is issued to finance a real estate project, the purchasers of the bond would participate in the risk associated with the project by having property rights over the project’s assets so that in the case of a failed project, their compensation would be limited to these assets. Thus, Islamic finance prohibits shifting the entire risk of the transaction to the borrower. The Quran prohibits debt-based contracts, but simultaneously ordains an alternative: a mutual exchange in which one bundle of property rights is exchanged for another, thus allowing both parties to share production, transportation, and marketing risks. It allows parties to enter into a contract to share, and thus reduce, the risk of income volatility.

In order to fit into this framework, the Islamic financial system would be a two-tier banking system. First, banks would accept deposits for safekeeping without accruing any return, and must maintain one hundred percent reserves. This protects the payment system of the economy, while concurrently limiting the credit-creating ability of the banking system. Second, an investment component would function as a financial intermediary, channeling savings into investment projects. Deposits in these investment banks would be considered equity investments with no guarantees for their face value at maturity, and subject to the sharing of profits and losses. Depositors would be investors in the pool of assets maintained by the investment bank on the asset side of its balance sheet.

These banks invest directly in real projects in every segment of the economy (except in prohibited activities like gambling and alcohol) and share in their attendant risk. An Islamic bank is assumed to match deposit maturities with investment maturities, with no need for asset-liability management. Short-term deposits may finance short-term trade operations, with liquidity replenished as sales operations generate profits. For long-term investments, longer-term deposits are used. In such operations, financial
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In place of debt, Islamic finance introduces securitized “asset-linked” securities. The key difference, between conventional securitization and asset securitization in Islamic finance is the end investor’s ownership rights, or access, to the securitized assets. In the conventional system, there are multiple layers of ownership, which may leave the final investor without any recourse in case of default. In the Islamic system, there are strict requirements of clear ownership rights for the investor. This feature affords a measure of stability because the same underlying asset is not traded multiple times, 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. Securitization in the Islamic system, on the other hand, is based on equity or risk-sharing, and thus the principal return would depend on the market value of the underlying asset. Again, this is an important structural element that reinforces financial stability.

An Islamic, asset-linked security complements the risk-return profile of a typical stock market security in one crucial way: while an equity share represents ownership in the equity capital of a firm and is thus exposed to general risk in the business of the firm, an asset-linked security represents a security where the investor’s return is linked to the
profit and loss of a pool of heterogeneous assets. As a result, the expected volatility of such asset-linked securities is lower when compared to a simple stake in equity capital, assuming that there is no change in the creditworthiness of the asset owner. Due to low volatility, asset-linked securities can cater to the needs of investors who would like more deterministic and low-risk returns.

The Building Blocks of the Islamic Financial System

To foster the development of Islamic finance in any country, first and foremost the system needs to emphasize risk-sharing. The bias against equity finance—or adverse taxation of equity finance relative to debt—must be removed in order for risk-sharing and equity finance to flourish. Additionally, given the importance of the stock market for equity finance, regulators should reduce the transaction costs of stock market participation, develop low-cost, efficient secondary markets for trading equity shares, and also promote long-term financing instruments. It is imperative to create a market-based incentive structure in order to minimize speculative behavior. Secondary markets would promote better distribution of risk, and achieve risk reduction by keeping expected payoffs in line with overall stock market performance. Absent true risk-sharing, Islamic finance may simply encourage debt-like, short-term, low-risk, and highly-liquid financing without manifesting the most important dimension of Islamic finance: its ability to facilitate high growth in employment and income with relatively low risk to individual investors and market participants.

Financial intermediation is at the heart of any financial system. Since those who invest are not necessarily those who save, efficient financial intermediation essentially channels savings to the most productive investments. Its traditional function has been to transfer savings to firms, entrepreneurs, and governments for investment, and increasingly to transfer risk to those who are better able to assume it. Historically, financial intermediaries have provided these services, but in recent years, financial and capital markets have progressively served the same functions. While intermediaries and markets could complement one another, enhanced competition between markets and intermediaries can be expected to increase efficiency and risk-taking.

Sensible institutions and governance are crucial for the development of a sustainable financial system. Given the moral hazard and agency problems associated with equity-based financial contracts, institutions that govern property rights and enforce the terms and conditions of contracts provide a reasonably strong basis for an economy based on risk-sharing, where information flows unhindered and participants engage in transactions confidently and with minimal uncertainty. As can be readily inferred, strict rule compliance is absolutely essential for an Islamic financial system to live up to its name and expectations. Human frailty being what it is, effective institutions and enforcement are essential prerequisites for a successful and stable financial system.

Despite its origins, the development of Islamic finance is limited even in Muslim countries themselves. In recent years, the number of Islamic banks and their assets has increased significantly and Islamic financial products, specifically sharia-compliant products, have been rapidly developed and sold by Islamic and non-Islamic banks
around the world. Nevertheless, while Malaysia has adopted policies that are moving its financial system toward one resembling Islamic finance, no country has a system that could be fully classified as such. Weak economic and financial infrastructure, inefficient and unreliable institutions, and underdeveloped human capital stymie the potential of a truly Islamic financial system in most Muslim countries. The ethical and moral practices demanded by Islam stand as one of the greatest underlying challenges of developing this system in a highly profit-hungry world. According to the Quran, a society must be based on a foundation of social justice, and individual members of society must be committed to ethical standards in all of their dealings. In such a setting, greed, corruption, and speculation would be minimized, and the government would develop and enforce rules that would benefit society.

The conclusion is simple. If policymakers want to eliminate recurring financial crises, they must discourage excessive borrowing, leveraging, and risk-shifting, and instead encourage risk-sharing and equity finance. While Islam offers a system that prohibits all debt, a significant reduction in debt financing in favor of risk-sharing is the essential ingredient to reduce and eliminate financial crises. If policymakers do not adopt fundamental reforms to reduce debt financing and leveraging, international contentions will grow: countries will begin to demand a say in the financial and budgetary policies of others countries in order to protect themselves from recurring financial crises and shocks that travel across national borders. Whether the reforms implemented are called the Chicago Plan, Limited Purpose Banking, or Islamic finance, the message is unified: the world needs a financial system that reduces risk-shifting and debt financing in favor of risk-sharing and equity financing in order to create a financial system that promotes growth and minimizes instability.

-- Debbie Gim served as Lead Editor for this article.

NOTES

2 Fisher, *100% Money*.
4 For details, refer to Hossein Askari, Zamir Iqbal, and Abbas Mirakhor, *Globalization and Islamic Finance: Convergence, Prospects, and Challenges* (Singapore: John Wiley & Sons, 2009), 73–76.