

Persistence of Islamic Banks in Financing Through Creation of Debt: Causes and Prospects

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Abstract: *Although Islamic banks are allowed to invest in businesses directly based on equity participation in addition to financing third party enterprises, in actual fact, direct investment by Islamic banks is not seen to have flourished due to a variety of factors, not the least among them being the identity inherited from the conventional industry as mere financial intermediaries, and legal impediments resultant of this identity. Despite of certain advantages as could be perceived in the equity mode, the conventional system of banking and finance is seen to be founded on debt financing with the interest-based loan as its primary building block, equity financing usually being the last resort. The conventional system has refused to share in the risk of the ventures financed in any manner, sufficing with the risk-free gain through interest income. Adoption of equity financing modes by Islamic banks themselves is noted to be less common than the use of debt-financing modes. The latter usually involve various adaptations of mark-up schemes, and are employed for the most part in short-term financing. The current paper seeks to discuss the above issues also exploring root causes and possible solutions.*

Keywords: debt, financing, Islamic, equity, banking

1. Introduction

In the equity-based financing mode where funds are provided as capital exposed to profit or loss, the liability remains with the provider to the extent of his capital, and no debt is created. This method, which could be called equity financing as it is based on contributing equity, comprises Islamic modes of financing such as mushārah and mudārah. Financial institutions may extend funds to their clients either in a manner where the seeker of funds becomes indebted to the institution, or through extending funds by way of capital participation in a joint venture, where practicable. The former, commonly referred to as debt-financing, includes means of financing such as extension of loans against interest or otherwise, sale on deferred payment, lease etc, where the process leads to the creation of a debt.

In addition to equity financing, economic ideals put forth by Islam as alternatives to debt financing also includes qard hasan or gain-free loan. However, the latter alternative could not be expected to play a significant role in business finance today under the prevalent commercial paradigm and its approach to money, as qard hasan is not purported to give rise to any material increase directly or indirectly. Prior to discussing issues pertaining to implementation, it is appropriate to provide a summary of equity financing and its relationship to debt financing

mainly from an economic perspective. Ideally, a large proportion of all business financing in an Islamic economy would be based on equity financing, where the financier shares in the profit and loss of the business financed.

2. Equity financing and debt financing: a comparison

In financing on the basis of equity participation, the funds provided increase the equity base of the venture, thus providing stability. This is because the funds required by the venture are injected as equity or capital that is entitled to a share of any profits realised through the venture, while being exposed to erosion or total eradication in the event of loss. The profit and loss both are distributed among all participants who contribute towards the equity, which is differentiates this mode of financing from debt financing. Thus, equity financing entails mutual sharing of risks pertaining to the enterprise and an equitable distribution of the return. The actual rate of return of all sharing parties will be determined *ex post* in accordance with the actual performance of the venture.

In conventional debt financing, additional finance sought is injected in the form of a loan at a predetermined rate of interest (Sadique. 2012). The funds injected come as a liability on the venture, which is to be repaid with the interest, according to the terms agreed. The funds do not play any role in increasing the equity base. They remain a foreign element as far as the assets of the venture are concerned, and do not take a constructive share in enhancing the networth. Therefore, even a large amount of funds injected as a debt serves only the purpose of inflating the cash position temporarily. Profit / loss of the venture is borne solely by the entrepreneur, the lender not being immediately concerned with this aspect. Irrespective of the ultimate profitability of the venture, the lender is entitled to receive the agreed amount of interest. Thus, risks are associated with the entrepreneur solely.

In profit sharing arrangements, only shares of expected profit are determined at the outset, while the actual rate of return on investments is to be determined in the end, on the basis of realised profits. However, debt, on the other hand, requires predetermined interest payments, and business difficulties may create pressures on the firm's cash flow, forcing it to forgo lucrative business ventures, borrow further, or sell its existing assets. As equity finance does not create such mandatory payment, the cost of adjustment to any contingency is lower (Othman, 1994). Therefore, proponents argue that in an advanced economy, equity financing should be the rule and not the last resort. Profit sharing provides more flexibility in meeting contingencies. This is because of the balanced distribution of gains as well as the risks among the participants in equity financing, while debt is restrictive and unforgiving, hence less stable (Othman, 1994).

Researchers have highlighted the property right imbalance in debt finance arising through the fixed nature of the interest element. One party, i.e. the lender, has some permanent and contractually guaranteed rights, while the other, the borrower, only has some temporary and residual rights. Such imbalance and asymmetry of property rights may entice opportunistic behaviour on the part of the borrower in several forms such as misappropriation of funds or forgoing altogether of what could otherwise be a profitable venture. On the part of the lender, should difficulties develop, he could resort to foreclosure and liquidate what could be a better business in the long run (Othman, 1994, p. 11).

In depositing funds with a bank under an equity arrangement, instead of being guaranteed for the face value of deposits, the depositors here are essentially shareholders whose returns vary

with the profits and losses of the bank. The situation could be even compared to accounts in mutual funds. This would render deposit insurance unnecessary, and there would be less likelihood of financial panics or runs. Research in the area of mutual-fund banking comes to the same conclusion (Akacem & Gilliam, 2002). Researchers also observe that under equity financing, assets and liabilities of the bank would move together due to the above reason. This, while relieving banking authorities from excessive regulatory oversight, would result in the net-worth values constantly giving an adequate read on the health of the financial institution (Akacem & Gilliam, 2002).

In debt financing, the possibility of refinancing brings about an uncertainty for both parties as to the nature of the future terms of the contract. It may even induce the debtor to liquidate to save as much as he can of the present value before foreclosure prevents him from saving his own equity. In a profit sharing arrangement, there is less incentive for this even if the expected average gross rate of return changes, due to the absence of a strict obligation of principal repayment on the entrepreneur. The return to the capital investor will be in accordance with the actual market conditions (Othman, 1994, p. 7).

In the equity based risk / reward sharing system, value judgements as well as strength of the proposal would both play an important role in the allocation of resources (Chapra, 1992, p. 332). Financing of any economic or business activity turns into an ownership stake, and banks have an incentive to make the joint venture work. They become fully involved in overseeing the project and make sure that the money is spent wisely (Akacem & Gilliam, 2002). Similarly, the equity arrangement should encourage the borrower to exert more effort in his endeavour and should lessen the moral hazard problem of underreporting profits (Othman, 1994, p. 8). The fusion between investment experience and financial experience found in the Islamic banking system could provide the maximum guarantee for sounder investment through the best possible utilisation of limited resources.

Equity financing in the practice of Islamic banks

The above was a brief exposition of some basic aspects pertaining to debt and equity modes of financing in the context of banking, from an economic perspective. Despite of certain advantages as could be perceived in the equity mode, the conventional system of banking and finance is seen to be founded on debt financing with the interest-based loan as its primary building block, equity financing usually being the last resort. The conventional system has refused to share in the risk of the ventures financed in any manner, sufficing with the risk-free gain through interest income. More surprisingly, adoption of equity financing modes by Islamic banks themselves is noted to be less common than the use of debt-financing modes (Sadique, 2007). The latter usually involve various adaptations of mark-up schemes, and are employed for the most part in short-term financing. Although Islamic banks are allowed to invest in businesses directly in addition to financing third party enterprises, in actual fact, direct investment by Islamic banks is not seen to have flourished due to a variety of factors, not the least among them being the identity inherited from the conventional industry as mere financial intermediaries, and legal impediments resultant of this identity. Debt-based structures frequently adopted by Islamic banks are *murābahah*, *ijārah*, *istisnā'*, and numerous variations based on these. Application of equity financing modes is seen to be less developed and adopted sometimes in unfavourable conditions where they may not function in a manner that could reveal their full potential.

It is necessary to analyse the causes for the lack of widespread application of equity financing modes in Islamic banking practice. In the discussion below, an attempt is made to study the

background to this setback, which had led to the prevalence of debt-based modes in the Islamic banking culture, instead of a genuine implementation of equity based structures. The problems faced in employing equity modes, and possible measures for advancement would be explored thereafter.

Background to the marginalisation/downgrading of equity modes

The economic measures advocated by shari'ah favours a system that leads to an equitable distribution of wealth, avoiding excessive concentration and deprivation.¹ Facilitating equity participation in trade and other undertakings that help the real fruits of ventures spread among a larger segment of the society while dividing the inherent risk is an important facet of an Islamic financial system. As such, a decisive and unambiguous introduction of genuine equity financing modes has been a vital goal in the establishment of Islamic financial institutions.

During their formative period, in order to compete with the well-established interest-based banking sector, Islamic financial institutions were hard-pressed to develop a viable scheme compatible with Islamic principles in a relatively short span of time. Due to the special constraints under which they had to operate at the time, shari'ah scholars had allowed them to resort to some trade oriented products that could serve the purpose of providing a permissible alternative to interest-based financing. Similarly, in employing methods of equity participation, in acquiring funds from investors as well as disbursement to entrepreneurs, aspects pertaining to capital, profit / loss sharing etc were subjected to some modification and amendment in order to facilitate ease of application in different areas of financing. These structures allowed elements of Islamic finance to be introduced in the field of modern banking and commerce in an experimental manner, in harmony with the prevalent norms and operational procedure. In order to win market approval and customer confidence, they were structured in a way that incorporated some aspects of conventional banking, and were planned to diverge from established banking practices only where it was essential. Thus, equity-financing modes that are employed by Islamic banks currently in many areas are seen to embody aspects that could be more readily related to debt financing.

Several decades after their appearance in the scene of banking and finance, Islamic banks continue to use debt-financing tools widely, and have not so far been successful in implementing equity modes in a significant manner. Some of the reasons cited for the limited employment of equity structures were discussed above under equity financing in the practice of Islamic banks. Nonetheless, the reality of the current Islamic financial scene is that a number of modes currently adapted by Islamic banks for financing purposes have little in common with investment and financing. These modes are not the perfect Islamic substitutes for the interest-based counterparts they are supposed to replace, but happen to be extensions of debt-based products that have been adapted to conform to shari'ah requirements for financing mediums. As stated earlier, while these modes constitute valid means of trading and commerce when utilised in their original contexts, their adoption for financing, often with a number of alterations for their suitability in a banking environment, is not devoid of negative aspects. Regardless of their admissibility or otherwise, continued operation of these modes could not be expected to realise the fruits of an ideal Islamic economic system, which result from a full-fledged implementation of Islamic equity modes.

1 Qur'anic verses on the division of booty, inheritance, payment of zakah, charity and spending of excess wealth etc. allude to this fundamental value. See Sūrah al-Hashr, 59: 7, and al-Baqarah 2: 219.

Due to the persistence of Islamic financial institutions in employing debt-financing structures as the main avenue of business, contemporary scholars have done a considerable amount of work in fine-tuning them and identifying solutions for difficulties faced in their implementation as a universal alternative for all types of interest-based loans. The efforts in this regard have been undertaken to ensure that such financing, although unsuccessful in realising Islamic economic objectives, remains within the broad limitations of the *sharī'ah*. However, considering the fact that debt financing is never the ideal Islamic alternative, and as such, could hardly be expected to curb the economic evils of the current system, debt-based tools appear to be grossly unworthy of the extensive work carried out by contemporary scholars and the ongoing discussion on the topic. Therefore, a major push by academic circles to incline Islamic financial institutions towards a sincere attempt at implementing equity modes appears timely, through increased discussion on the topic and removing major hurdles on the way.

This is especially relevant in view of the fact that the transition from interest-based banking to an Islamic setup was primarily undertaken to ensure adherence to *sharī'ah* norms. Unless the latter intent is realised satisfactorily, efforts taken in this regard are in danger of becoming an exercise in vain. The reality of equity financing becoming merged with debt-oriented practices due to erroneous or weak structures gaining currency may prove harmful to the cause of Islamic finance in the long-term, and require to be arrested in time. With growing awareness of the negative facets of debt financing, scope for equity modes could expand in the near future. Therefore, it is essential that necessary guidelines are laid down and complexities dealt with in time for ready application.

Problems in implementing equity structures

While some have gone so far as to question the sincerity of Islamic banks in devising workable interest-free alternatives, i.e. based on equity participation, reasons cited by others for the lukewarm interest shown by current-day Islamic financial institutions in implementing equity structures carry some similar themes. A major factor could be that equity financing is commonly perceived as difficult in operation. This perception appears to arise from the conventional banking standpoint, where equity financing is considered specialized business carrying drawbacks such as risk, difficult nature, long gestation period and potential involvement in management. *Mudārabah* financing is assessed to have more agency problems compared to conventional debt or equity financing. Obligation to oversee projects in which they are partners is another potential deterrent. This requires managerial skills and expertise in overseeing different investment projects (Akacem & Gilliam, 2002). Clients and projects to be financed require more careful evaluation.

It has been pointed out that costs and other requirements pertaining to auditing and monitoring internal performance and related issues are part of set-up costs, which are needed irrespective of the form of finance (Othman, 1994, p. 4). Others argue that debt financing only bypasses the need for information by requiring collateral and creditworthiness to ensure repayment of principal plus fixed, predetermined interest. The issue of information cost in the profit loss sharing system, i.e. equity financing, has to be judged by comparing the benefits of collecting information with the costs associated with it. Moreover, in a bank-client relationship, it is hardly likely that the client would contemplate of only a single transaction with the bank and be tempted to withhold information. In the context of the need for a continued bank-client relationship and competitive demand for bank finances, the problem of information asymmetry poses less of a problem. In fact, the issue exists in all market transactions, which is taken care of through credit rating and other measures. Institutions and conventions could be developed, when those in existence are considered inadequate, to restrict gains from fraud (Khan, 1995, p.

241). It should be conceded in this regard that within profit loss sharing techniques, *mushārah* might have an edge over *mudārah* in the sense that in *mushārah*, the capital owner has a right to enter into the management and hence have some control over the problems created by information asymmetry and moral hazards (Khan, 1995, p. 99).

Therefore, although some have suggested asymmetry of information as an explanation of why profit loss sharing has failed to prevail in a competitive market despite of being superior to the interest-based system or mark-up based techniques, others have highlighted the fallacy of this supposition as outlined above. Thus, it is necessary to investigate other causes for this phenomenon. A major hurdle could be the economic structure, which may have a bias in favour of the interest-based system rather than a profit and loss sharing arrangement. Tax structures are regarded unfavourable to equity formats. While interest payments are deductible expenses and result in reducing the tax burden, adopting equity financing thus claiming a share in profits could increase tax liabilities for the entrepreneur. Some researchers have shown that the only advantage of debt financing vis-à-vis equity financing is the tax savings generated by the former (Modigliani & Miller, 1980).

Another important reason that prevents equity schemes coming into practice is the simultaneous presence of the interest option. Interest is a convenient, less effort-requiring option for both parties, and drives out profit loss sharing on analogy with Gresham's Law of bad money driving out good. The existence of an inferior product and absence of a superior product is possible on various non-economic grounds. Convenience may outweigh economics, due to the fact that adopting an equity basis places additional burdens on the capital owner such as vigilance over the operation of the project and bearing of financial loss, while entrepreneurs could be willing to undertake fixed payments rather than share profits or responsibility. Since there are capital providers who can afford to forego possible advantages for the sake of convenience and entrepreneurs who can afford to bear all the risk of loss, if any, interest rates and mark-up schemes tend to drive out profit and loss sharing mediums. Similarly, the tendency to reserve capital away from risk even at the cost of a lower return, and the facility provided by debt financing of earning interest even on consumption loans too have been identified by researchers as factors that prevent capital-owners from seeking profit loss sharing ventures with investors (Khan, 1995, pp. 242-44).

Based on the above, some modern Muslim economists conclude that as long as interest is allowed to prevail in the economy, an Islamic financing technique based on profit and loss sharing cannot prevail. Similarly, despite of the higher efficiency of profit and loss sharing techniques in most of the operations in the economy, they may remain in the background as long as the option of mark-up based techniques is available to capital providers. However, as mark-up based techniques have a basis in *sharī'ah*, they may not be eradicated as interest. Therefore, these economists suggest that in the long term, Islamic commercial banks must be gradually prohibited from involvement in mark-up based activities, as is the case with non-Islamic banks usually. Thus, commercial banks would have no option but to deal on an equity platform. There could be specialised banks carrying out trading and leasing based on mark-up (Khan, 1995, p. 245). These economists feel that without such efforts, profit / loss sharing scheme will never be enforced, and will remain in use only to the extent to which equity participation is in use in the activities of interest-based banking.

Although the above suggestion appears to be an extreme measure unlikely to be sought in the immediate future, there is no gainsaying the fact that if equity financing is to be promoted with any measure of success, some restriction should be introduced, either through legislation or

through shari'ah directives based on *maqāsid al-shari'ah* by shari'ah supervisory boards, on the proliferation of mark-up based debt-finance schemes in areas of financing. While such formats could be adopted with observance of shari'ah guidelines in their original contexts, i.e. in bona-fide trading and leasing, their extensive adoption for financing purposes may require revision.

When banks find themselves obliged to adopt equity financing, it could reasonably be assumed that speedy solutions may be found to many of the obstacles perceived currently. Customer education, and to a larger extent, a change of the identity of the bank too appear imperative. It should be noted that as long as Islamic banks maintain their inherited image of a mere lender and financial intermediary, they would hardly be considered entitled a share in the profits. Ensuring willingness of the clients to adopt equity modes could primarily depend on Islamic banks creating for themselves an image of a vibrant business partner who could contribute positively to the success of the venture. With the resources available at the disposal of a banking institution, this should not prove unachievable, especially in view of the higher returns such a change could generate. Management of Islamic banks, instead of being assigned solely to personnel trained in conventional banking, could be opened for more involvement of business expertise. This could solve aspects such as information asymmetry and agency problems while also moderating the temperament of extreme risk aversion typical of conventional banking, bringing a level of commercial approach to investment and finance.

Based on the above discussion, it could be assumed that, should Islamic banks make a decisive effort to employ equity-based modes on a wider platform, possibility thereof is not non-existent. Although modes based on debt financing could be adopted in instances such as facilitating acquirement of assets and usufructs, a general reliance on debt-based modes for financing purposes could result in the non-realisation of Islamic economic objectives. The moral responsibility of Islamic banks too should not be lost sight of. The developmental nature of an Islamic bank means that it has to exert persistent and continuous efforts to improve and diversify its investment in order to achieve satisfactory results for society, shareholders, depositors and partners, which could be best done through broader involvement in equity financing.

3. Conclusions

It could be readily understood that Islamic banking structures as alternatives to interest-based modes are in need of continued review and improvement. This is especially true of equity financing modes currently adopted, which presented a novel concept in banking at the time of their introduction by Islamic banks. As such, these are seen to be based on formats originally developed mainly for survival and competition in a predominantly hostile setup. Practical involvement in the field of Islamic banking would reveal that current equity structures comprise various areas that call for a reassessment in the light of shari'ah principles. Therefore, with the experience gained through implementation over a period, a careful scrutiny of prevalent equity financing techniques could be appropriate in order to assess the level of their shari'ah standing. In addition, with Islamic banking gaining a firm foothold in the banking and commercial sectors, a more dynamic approach to promulgating the shari'ah ideals of equity participation appears timely.

In the situation described above, there appears a strong possibility that equity financing structures currently adopted could be developed further to ensure a higher level of shari'ah conformity while curing some of the negative aspects, so that their full potential could be adequately revealed. A vital area in this regard is the nature of capital contributed towards

equity relationships. A cursory perusal of Islamic legal texts reveals that considerable emphasis has been placed on the existence and availability of capital at the formation of equity partnerships. This is seen to result in important consequences pertaining to the involvement and liability of the partners. The practice of Islamic banks in this regard does not appear to reflect this aspect adequately. The nature of this shari'ah requirement and the possibility of its realisation in the modern fiscal environment needs to be examined, especially in the context of deeper connotations it may carry with regard to constancy and stability of money supply. Employment of non-liquid assets as the capital base of equity relationships too demands verification.

Profit and loss distribution in equity ventures is a fundamental issue that determines the outcome of Islamic equity financing modes and the extent of influence they could exert on directing the flow of wealth. Contrary to the interest-based system that has a tendency to aid in the concentration of wealth, equity modes are expected to dissipate the latter aspect. The mechanism employed by Islamic banks in deciding the ratio of profit sharing may require further refinement. Alternative methods that could be employed for the purpose need to be explored. Stipulations purporting to facilitate one of the partners achieve a near-certain amount of profit need to be weighed up with regard to their admissibility.

In some variations of equity investment adopted by Islamic banks, the profit loss sharing mechanism is found to be correlated to the period of the facility in some manner, through ensuring an association between the profit ratio and the duration of investment. This is especially true of investment and savings accounts offered by Islamic banks, where depositors enter in to a contract of investment with the bank for sharing profits realised through utilising deposited funds in business. For profit distribution among depositors, Islamic banks generally adopt a method where the profit is calculated based on both the amounts that had remained in the account and the respective periods. This basis, although widely in use, is in need of further scrutiny, to ensure that it is in keeping with the just distribution of gains and liability which forms the core principle of equity participation in shari'ah.

Structures employed for project financing through equity participation could be further enhanced to reflect the essential aspects that differentiate them from interest-based modes. Currently adopted equity formats may embody features that inhibit them from optimum performance. In addition to financing complete projects, funding of ventures in progress too could be carried out on an equity basis with advantage. Currently, Islamic banks employ murabahah-based structures in general to facilitate foreign trade transactions, albeit with a considerable level of inconvenience. Involvement of foreign exchange makes adopting murabahah here a complicated process, endangering shari'ah compatibility at times, and paving the way for hidden and doubtful gains to the financial institution. Adopting an equity format could solve a number of problems from an Islamic perspective, in addition to bringing the transaction closer to justice and fairness.

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