Islamic Banks' Dilemma Between Ideals And Practice: Debt Or Equity

Muhammad Abdurrahman Sadique,

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Abstract Equity financing modes currently adopted by Islamic banks are seen to be based on debt-based formats, originally developed for implementation in in interest-based financing system. With the experience gained over a period, a careful scrutiny of prevalent equity financing techniques could be appropriate in order to assess the level of their success in achieving Islamic economic objectives. With Islamic banking gaining a firm foothold in the banking and commercial sectors, a more dynamic approach to promulgating the ideals of equity participation appears timely.

I. Introduction

Providing finance could materialise either in a manner where the seeker of funds becomes indebted to the provider, 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 the latter 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 latter method, which could be called equity financing as it is based on contributing equity, is the recommended avenue for all venture-financing done by Islamic banks, from a theoretical perspective. In addition to equity financing, Islamic economic ideals proposed as alternatives to debt financing also include qard hasan or gain-free (i.e. interest-free) loan. However, under the prevalent commercial paradigm and its approach to money, this alternative could not be expected to play a significant role in business finance today, as such loans are not purported to give rise to any material increase directly or indirectly.

Thus, 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. This article attempts to study the possible outcomes of financing based on debt vis-a-vis equity-based financing in the context of Islamic economic ideals, and to analyse problems faced by Islamic banks in adopting an equity-based approach to financing in an earnest manner

[1] Umer Chapra, Towards a Just Monetary System, London, The Islamic Foundation, 1985, p. 68

About- Ahmad Ibrahim Kulliyyah of Laws
International Islamic University Malaysia

II. Equity financing and debt financing: a comparison

It would be worthwhile to undertake a review of the possible practical reasons why the Islamic economic system gives preference to an equity-based approach to financing ventures. It is argued that in financing on the basis of equity participation, 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 funds increase the equity base of the venture, thus providing stability. 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. 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. 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

[2]Usamah A Othman, "Debt and equity contracts in the theory of social economy" (1994) vol. 3, No. 1 Review of Islamic Economics 5.
[3]Ibid.

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.

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. 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.

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.

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. 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. 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. The fusion between investment experience and financial experience found in the Islamic banking system could provide

[4]Othman, p. 11.
[5]Tyler Cowen, Randall Kroszner, "Mutual fund banking: a market approach," (1990) vol. 10 No. 1 The Cato Journal 227, in Mohammed Akacem, Lynde Gilliam, "Principles of Islamic banking: debt versus equity financing" (March 2002) vol. 9 No. 1 Middle East Policy 124(15).
[6]Akacem, Gilliam above.
7Othman, p. 7.
[8]M Umer Chapra, Islam and the Economic Challenge, Leicester, The Islamic Foundation, 1992, p. 332.
[9]Akacem, Gilliam above.
[10]Othman, p. 8.

the maximum guarantee for sounder investment through the best possible utilisation of limited resources.

III. 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 Islamic 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. 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, istisnāʿ, 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.

The tendency among Islamic banks has been to invest in short-term deals, due to the apprehension that involvement in long-term equity projects could affect regular payments of profit to depositors, a necessary aspect in competing with conventional banks. Such aversion to long-term investment reduces the efficiency of Islamic banks in the long run. In the Malaysian context, Islamic banking is concentrated in the individual customer sector and not in commerce and industry. Despite of the fact that short-term financing, involving trade financing and other types, performs an important economic function, such financing does not cause the creation or increase of additional production capital, on which real economic growth rests. Thus, emphasis on short-term financing would not be congruent with social needs

[11]M A Mannan, Islamic Economics: Theory and Practice, Delhi, Idarah-i Adabiyat-i Delli, 1970, p. 226.

The Japanese experience could provide a real-time example. By engaging in joint debt-equity finance, the Japanese bank is able to address the agency problem of information asymmetry (Amir Barnea, Robert A Haugen, Lemma W Senbet, Agency problems and financial contracting, Prentice Hall, 1985, p. 38, in Akacem, Gilliam above.) Since the bank is now part owner, it has access to more information on the firm and in turn achieves efficiency gains in monitoring (Sun Bae Kim, “The use of equity positions by banks: the Japanese evidence” (Fall 1991) The Economic Review, Federal Reserve Bank of San Francisco 41, 43, in Akacem, Gilliam above.)

[12]Saad al-Harran, “Equity Financing” (Nov & Dec 1994) vol. 5 no. 3 The American Journal of Islamic Finance 8.

[13]Nik Mohamed Affandi bin Nik Yusoff, Islam & Business, Selangor, Pelanduk Publications, 2002, p. 55.

[14]Obiyathulla Ismath Bacha, “Conventional versus mudārabah financing: an agency cost perspective” (1995) vol. 4 nos. 1 & 2 Journal of Islamic Economics 35

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. Clients and projects to be financed require more careful evaluation.

While some of the above factors had been partially addressed in the foregoing appraisal of equity financing and debt financing, some additional responses could be reviewed here. 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. 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. It should be conceded in this regard that within profit loss sharing techniques, mushārakah might have an edge over mudārabah in the sense that in mushārakah, 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.

[15]Tarek El Diwany, Muhammad Nejatullah Siddiqi, “A discussion with professor Siddiqi – June 2006,” <http://www.islamic-finance.com> viewed on 15.06.2006.

[16]Al-Harran, p. 7.

[17]Bacha, p. 45.

[18]Akacem, Gilliam above.

[19]Othman, p. 4.

[20]M Fahim Khan, Essays in Islamic Economics, Leicester, The Islamic Foundation, 1995, p. 241.

[21]Fahim Khan, 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.

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 form 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.

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 Islamic law, they may not be eradicated as interest. Therefore, these economists suggest that in the long term, Islamic commercial banks must be gradually barred 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. 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 on the proliferation of mark-up based debt-finance schemes in areas of financing should be introduced. This could be either through legislation or through sharīʿah supervisory boards of Islamic banks.

When Islamic 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

IV. Conclusion

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 ethical 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

[22]F Modigliani, M H Miller, "The cost of capital, corporate finance and the theory of investment," in A Abdel (ed), The Theory of Finance and Other Essays, Cambridge, The MIT Press, 1980, vol. 3, in Fahim Khan above, p. 241.

[23]Gresham's law: in economics, the tendency for money of lower intrinsic value to circulate more freely than money of higher intrinsic and equal nominal value (often expressed as 'Bad money drives out good'). Formulation of this principle is attributed to Sir Thomas Gresham [d. 1579, Eng. financier and founder of the Royal Exchange.]

[24]Fahim Khan, pp. 242-44.

[25]Fahim Khan, p. 245.

[26]Al-Harran, p. 9.