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David Cobham\*

# Finance for Development and Islamic Banking

*Islamic banking, where fixed interest contracts are banned, needs if it is to be successful to operate within a type of financial system in which bank-industry relationships are sufficiently close and pervasive for profit- and loss-sharing arrangements to be acceptable to both sides. However, the creation of such a business culture is likely to be difficult.*

The Quran prohibits *riba*, which is generally taken to include all forms of interest payment. In this, Islam has much in common with a number of other pre-capitalist ideologies, including notably mediaeval Christianity and (at least as far as loans between Jews were concerned) Judaism. In Europe the ban was abandoned in the seventeenth century in the context of the Reformation. In the Middle East the ban seems rather to have lapsed (partly under the impact of the spread of Western economic influence in the 19th and 20th centuries), but has been revived more recently. The first modern Islamic bank was established in Mit Gharni in Egypt in 1963, and a wide range of such banks were set up in the second half of the 1970s and the first half of the 1980s. The prohibition of *riba* has also formed the underlying basis of the banking laws of Iran and Pakistan since 1983 and 1985 respectively.

The broad viability of Islamic banking has now been clearly established.<sup>1</sup> Lending can be carried out with the lender receiving a share in the profits generated rather than a fixed return on his or her loan, through partnerships such as *mudaraba* – a form of sleeping partnership in which the borrower controls the capital provided – and *musharaka* – a more active partnership in which the lender and the owner/manager of a firm direct its affairs together. Deposits placed with an intermediary can similarly be either interest-free or profit-and-loss-sharing (PLS); the latter carry an entitlement to a share in the profits of the bank from relevant lending operations.

In this paper the feasibility of Islamic banking will be taken for granted, and issues such as the stability of the banking system,<sup>2</sup> the operation of monetary policy in an

Islamic system,<sup>3</sup> and the effects of adopting an interest-free financial system on savings and investment<sup>4</sup> will be neglected. Instead, the focus is on the implications of the prohibition of interest for the financial system as a whole. The paper first discusses the reasons for the existence of banks and the reasons why debt contracts with fixed interest payments are regarded in the analytical literature as optimal. This is followed by a consideration of the stylised contrast between Anglo-Saxon and German-Japanese financial systems. The difficulties involved in government borrowing are then pointed out. Finally, the implications for the financial structure of a developing country of the Islamic ban on interest are outlined.

## The Role of Banks

Why do banks exist and why do they charge/pay interest?<sup>5</sup> The traditional answer to the first part of this question is two-fold. First, it is argued that banks mediate between the different preferences of lenders (depositors)

<sup>1</sup> See, for example, I. Karsten: Islam and financial intermediation, IMF Staff Papers, 29, 1982, pp. 108-42; F. L. Pryor: The Islamic economic system, in: Journal of Comparative Economics, 9/1985, pp. 197-223; N. A. Saleh: Unlawful Gain and Legitimate Profit in Islamic Law, Cambridge University Press, 1986; Z. Iqbal and A. Mirakhor: Islamic Banking, IMF Occasional Paper No. 49; S. Ahmed: Islamic banking and finance: a review essay, in: Journal of Monetary Economics, 24/1989, pp. 157-67; and the collection of papers in M. S. Khan and A. Mirakhor (eds.): Theoretical Studies in Islamic Banking and Finance, Institute for Research and Islamic Studies, Houston 1987.

<sup>2</sup> See, for example, M. S. Khan: Islamic interest-free banking: a theoretical analysis, in: IMF Staff Papers No. 33, pp. 1-27.

<sup>3</sup> See, for example, M. S. Khan and A. Mirakhor: The financial system and monetary policy in an Islamic economy, in: M. S. Khan and A. Mirakhor (eds.), op. cit.

<sup>4</sup> See, for example, N. U. Haque and A. Mirakhor: Saving behaviour in an economy without fixed interest, in: M. S. Khan and A. Mirakhor (eds.), op. cit.; N. U. Haque and A. Mirakhor: Optimal profit-sharing contracts and investment in an interest-free economy, in: M. S. Khan and A. Mirakhor (eds.), op. cit.

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and borrowers: the former typically prefer short term liquid assets, and the latter long term illiquid liabilities. Banks issue claims of the kind which depositors prefer to acquire and purchase the different claims which borrowers prefer to issue, thus transforming the maturities and other elements of the claims. In this banks can be contrasted with organised financial markets such as those for equity or bonds, in which firms (borrowers) issue claims of a perpetual or long term kind which lenders can liquidate if they wish by selling them on to other investors rather than asking the issuer to redeem them.

The second part of the traditional answer stresses the ability of banks as specialist financial intermediaries to benefit from economies of scale: by operating at a high volume banks incur lower average costs, particularly in the gathering of information on potential borrowers and in the management of portfolios. These points have been reinforced by recent work on banks as providers of insurance and on financial intermediation as delegated monitoring.

These answers create little difficulty for Islamic banking since they do not require financial intermediation to be interest-bearing. However a third answer to the question has been developed in the 1980s, which turns out to have more powerful implications for Islamic banking. This newer analysis draws on the literature on imperfect information and transactions costs. This literature has made clear that where information is imperfect markets are not always efficient and trading may occur at a sub-optimal level and/or at non-equilibrium prices. Moreover it is clear that credit markets are highly susceptible to information imperfections, since typically borrowers know better than lenders the general creditworthiness of their enterprises, the likely return on future investment projects and the realised return on completed projects. At the same time the costs of setting up and operating secondary markets in financial claims are high enough to make secondary markets non-viable except for claims issued by large firms in which likely turnover is substantial; and in that case primary issues of debt by other borrowers are also excluded as too expensive.

Thus banks can be considered as mechanisms that compensate for the absence of secondary markets in conditions of imperfect information: they enable finance to

be provided indirectly from ultimate lenders to ultimate borrowers in situations where direct financial flows are not possible. They do this by specialising in the gathering of information and by developing relationships which enable borrowers to provide private information which they would not wish to see made public; and they protect themselves by pooling the risks to which they are exposed and by keeping a small reserve of liquid assets in their portfolios.

### Optimal Debt Contract

The second part of the question which opened this section has been studied only recently. The problem is, what sort of contract between lender and borrower is most efficient, given imperfect information? It turns out<sup>6</sup> that the optimal, incentive-compatible, contract is the so-called "standard debt contract" in which the lender (a) charges a fixed interest payment related to the size of the loan and (b) imposes a non-pecuniary penalty for non-payment (i. e. bankruptcy) and/or demands the posting of collateral by the borrower. This sort of contract clearly dominates other sorts, e. g. a variable-return equity participation in which the return to the lender depends on the outcome of the investment project. The intuitive explanation is that the standard debt contract minimises the monitoring which the lender is obliged to undertake: since its return is independent of the success of the project it does not need to concern itself with the outcome, while the non-pecuniary penalty and/or collateral ensures that the lender will be repaid. If the same question is asked about the optimal contract between depositor and intermediary, the answer is, again, a fixed interest rate contract, with default made unlikely by the diversification of banks' portfolios and their holdings of reserves.

According to orthodox economic theory, then, the optimal arrangements between ultimate lenders and financial intermediaries and between intermediaries and ultimate borrowers involve interest payments that are fixed, in the sense that they are dependent only on the size of the financial transaction and not on the outcome of the project for which the loan is used. If interest payments are not allowed, because of a prohibition on *riba*, it must be expected either that less financial intermediation will take place, because its costs are higher and ultimate lenders and borrowers choose therefore to lend and borrow less, or

<sup>5</sup> For surveys of the relevant literature see C. A. E. Goodhart: Money, Information and Uncertainty, 2nd edition, London 1989, chapter V; M. K. Lewis: Theory and practice of the banking firm, in: C. J. Green and D. T. Llewellyn (eds.): Financial Markets and Institutions, Oxford 1991; and J. Chant: The new theory of financial intermediation, in: K. Dowd and M. K. Lewis (eds.): Current Issues in Financial and Monetary Economics, London 1992.

<sup>6</sup> See, in particular, D. Gale and M. Hellwig: Incentive-compatible debt contracts: the one-period problem, in: Review of Economic Studies, 52/1985, pp. 647-63.

<sup>7</sup> Cf. the analysis of W. M. Khan (Towards an Interest-free Islamic Economic System, The Islamic Foundation, Leicester 1985). Khan does not discuss the theory of financial intermediation as such, but compares debt and equity finance in a principal-agent setting, with and without informational asymmetries and monitoring costs. He puts a heavy emphasis on the adoption of Islamic ethics as a way of eliminating monitoring costs, but also argues for the invention of "financial schemes embodying incentive mechanisms, so that agents reveal the truth even if they are not sufficiently afraid of God" (p. 105).

that some different structure of information flows might emerge which greatly reduces the kind of informational imperfections assumed in the orthodox literature discussed above.<sup>7</sup>

### Overall Financial Systems

A stylised distinction can be made between the UK and US ("Anglo-Saxon") financial systems and the German and Japanese ones.<sup>8</sup> In the former stock markets are relatively well developed, while relationships between firms and banks are at arm's length. In the latter, on the other hand, stock markets are less developed but firms have close relationships with their banks. In Japan this relationship typically takes the form of a "main bank" in a group of firms holding significant equity in the other firms as well as providing ordinary loans; in Germany it occurs through bank holdings of equity and, in particular, through interlocking directorships.

What are the information structures in the two cases? In the Anglo-Saxon model, owners and managers of firms prefer to preserve the maximum confidentiality over their affairs, but provide some information to their banks in order to obtain finance; that information is then protected by the banks' need to maintain their reputations for discretion. In the German-Japanese case firms provide much more information to their banks since the latter are represented on their boards, but that information is protected by the banks' own involvement in the success or failure of the firms. Thus there is a much greater level of "commitment" by both banks and firms to long term relationships.

### Relative Merits

In developed countries at least, there is room for debate about the relative merits of these two types of financial system. On the one hand, the greater commitment in the German-Japanese model may encourage firms to choose investment projects on the basis of a longer term profit horizon. For example, if a firm needs new finance each period then under the Anglo-Saxon model it may feel obliged to choose projects with higher immediate return over projects with low immediate but higher long run return, in order to ensure that it can obtain fresh finance in the next period; whereas under the alternative model the banks know whether firms are choosing the longer term

projects, they know that they themselves will benefit in the long run, and they will therefore still provide finance in the next period. Under the Anglo-Saxon model the supplier of finance knows that its customer can choose another supplier in the next period, so it demands a high return now; whereas in the German-Japanese case the firm has an incentive to stick with the same bank because of the information already provided and because the bank has part control through its directorships. On the other hand, the inability of firms to shop around between suppliers of finance in the German-Japanese case, with the lack of competition this implies, may make the firm more susceptible to opportunistic pressures from banks.

For developing countries, however, it seems much easier to argue that the German-Japanese model is the more appropriate.<sup>9</sup> On the one hand firms are typically smaller, so that secondary markets are more expensive to operate. On the other hand information imperfections are typically greater, in terms of the transparency of accounting and auditing procedures, the lack of an inquisitive financial press, and the strength of legal and property rights arrangements. Thus the costs of operating the Anglo-Saxon model will be higher, and the benefits lower.

### Government Borrowing

So far the focus has been exclusively on the private sector. However, the prohibition of interest has implications also for borrowing by the public sector. Indeed these implications are if anything more serious, since government borrowing to finance budget deficits cannot easily be fitted into the profit-sharing mode: partnerships would be feasible only for a limited range of specific projects, and would entail an element of privatisation which may not be desired for other reasons. Moreover, the problem applies to government borrowing from the nonbank private sector just as much as from banks.

The interesting suggestion by Karsten<sup>10</sup> that governments could issue bonds whose return would depend on the overall growth rate of the economy has not been taken up; it is in any case not without its own difficulties.<sup>11</sup> The alternatives seem to be to finance deficits out of monetary expansion via issues of banknotes or interest-free loans from banks, or to eliminate deficits altogether. While the latter might preclude fiscal profligacy

<sup>8</sup> See C. Mayer: *New issues in corporate finance*, in: *European Economic Review*, 32/1988, pp. 1167-89; M. Hellwig: *Banking, financial intermediation and corporate finance*, in: A. Giovannini and C. Mayer (eds.): *European Financial Integration*, 1991. The distinction is sometimes described as that between "market-based" and "bank-based" financial systems, or – with an emphasis on the control of enterprises – between "outsider-control" and "insider-control" systems; see also J. Corbett and C. Mayer: *Financial Reform in Eastern Europe: progress with the wrong model*, in: *Oxford Review of Economic Policy*, 7/4, 1991, pp. 57-75.

<sup>9</sup> See, for example, P. Collier and C. Mayer: *The assessment: financial liberalisation, financial systems and economic growth*, in: *Oxford Review of Economic Policy*, 5/4, 1989, pp. 1-12; and J. E. Stiglitz: *Financial markets and development*, in: *Oxford Review of Economic Policy*, 5/4, 1989, pp. 55-68. For a similar argument on the liberalising Eastern European economies see J. Corbett and C. Mayer, *op. cit.*

<sup>10</sup> I. Karsten, *op. cit.*

it would also deprive governments of a potentially useful policy instrument; the former ties fiscal policy rigidly to monetary policy in a way that also precludes its independent use. The two governments which have confronted this problem in practice have taken rather different views.<sup>12</sup> In Iran the government borrows at zero interest from the banking system, arguing that it owns the (nationalised) banking system anyway so that the payment of interest would be a spurious transfer between parts of the public sector. In Pakistan, on the other hand, the government borrows from the private sector at a predetermined rate which is in fact higher than that on PLS deposits, so that it attracts funds away from the banking system in a process of disintermediation.

### Implications of the Ban on Interest

At first sight the Islamic ban on interest might appear to favour the Anglo-Saxon type of financial system, with a well developed stock market and a high level of variable-return equity financing, though it should be noted that Islam prohibits speculation (*gharar*) as well as interest.<sup>13</sup>

However, the amount of net financing provided to industry as a whole from the stock markets in the US and the UK is in fact very low, lower than that in Germany or Japan, and American and British companies rely heavily on internal financing.<sup>14</sup> In addition, as argued in the previous section, considerations of imperfect information and transactions costs make the Anglo-Saxon model less appropriate for developing countries. The Islamic ban on interest should therefore be understood as favouring a German-Japanese model, in which banks have much more information about (and long term commitment to) the firms to which they lend. Banks need such information if they are to undertake PLS lending, while firms need such commitment if they are willingly to divulge the information required. The German-Japanese systems do, however,

involve substantial fixed-interest credits from banks to firms as well as equity participations, so that Islamic banking is likely either to be less flexible (and therefore less conducive to economic development) or to involve even closer bank-firm relationships.

### Concluding Comments

The analytical arguments of the previous sections suggest that to be successful Islamic banking needs to operate within an extreme form of the German-Japanese financial system. It would therefore have to be embedded in a business culture of a particular kind, perhaps one in which industrial-financial conglomerates predominate in a formal sector surrounded by, and given flexibility by, a large informal sector which relies mainly on trade credit from the conglomerates and internal financing. An Islamic financial system is thus feasible, but it is likely to be difficult to bring into effective operation.

So far it has indeed proved difficult to implement Islamic banking. There is a dearth of up to date empirical evidence on the performance of Islamic banks and banking systems. But the following broad generalisations can probably be substantiated: (a) in Iran and Pakistan it was relatively easy to "Islamicise" the liability side of banks' balance sheets; (b) but in these countries and in individual Islamic banks elsewhere the proportion of bank lending done on a genuine PLS basis remains much lower than Islamic precepts seem to suggest, for reasons that concern both the supply and the demand side. In particular, implementation has been hindered in Iran by the weakness and lack of confidence of the private sector generally, and by the shortage of personnel in the commercial banks with adequate expertise in Islamic modes of financing; and in Pakistan by the extreme caution of policy-makers and bankers and by difficulties in monitoring in an environment where multiple account books are common.<sup>15</sup> On the other hand, the development of the Bank Islam Malaysia,<sup>16</sup> an Islamic bank coexisting with a wide range of conventional banks, has been affected by adverse selection (a disproportionately high number of poor-risk potential borrowers who have already been turned down by conventional banks) and by a resentment on the part of many businessmen of the idea of sharing ownership and control with a bank in the way required.

The obstacles to the effective implementation of Islamic banking thus clearly relate to the prior existence of an inappropriate business culture. Moreover, it is not obvious how the requisite changes in business culture can be brought about. Countries which choose to pursue the Islamic option may therefore find themselves incurring substantial costs for very little return.

<sup>11</sup> For example, with counter-cyclical fiscal policy deficits, and the need to borrow, would be higher when growth, and therefore the return to be expected on government debt, would be lower.

<sup>12</sup> See M. S. Khan and A. Mirakhor: Islamic banking: experiences in the Islamic Republic of Iran and in Pakistan, in: *Economic Development and Cultural Change*, 38/1990, pp. 353-75.

<sup>13</sup> See N. A. Saleh, *op. cit.* The most widely quoted reference on the stock exchange in an Islamic system is M. M. Metwally (The role of the stock exchange in an Islamic economy, in: *Journal of Research in Islamic Economics*, 2/1984, pp. 21-30) which models the Islamic stock market as having a kinked supply curve for a security, with the supply curve horizontal at the maximum permitted price: clearly such a stock exchange would be very different from the Anglo-Saxon type.

<sup>14</sup> C. Mayer, *op. cit.*

<sup>15</sup> M. S. Khan and A. Mirakhor: *Islamic Banking ...*, *op. cit.*

<sup>16</sup> See T. Naughton and B. Shanmugam: Interest-free banking: a case study of Malaysia, in: *National Westminster Bank Quarterly Review*, February 1990, pp. 16-32; and M. Ariff: Islamic banking in Malaysia: framework, performance, and lessons, in: *Journal of Islamic Economics*, 2/1989, pp. 67-78.