COMMENTS on: "Choice between debt and equity contracts and asymmetrical information: Some empirical evidence" by Qazem Sadr and Zameer Iqbal

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The economics of information is one of the recent developments in the area of economic theory. Its use in the field of Islamic banking and finance is widely discussed. But there is still a lack of empirical studies. The authors should undoubtedly be commended for producing a thought-provoking chapter on the subject. They have presented empirical evidence from the experience of the Agricultural Bank of Iran (ABI) showing that a reduction in information asymmetry and increased monitoring by the ABI led to the preference of variable return instruments (VRIs) such as *musharakah, mudarabah* over the fixed return instruments (FRIs), like *murabahah, ijarah, bay' al-salam,* and so on. According to the authors, with increased supervision and monitoring, information asymmetry is minimized and under such circumstances it is not efficient for the financial intermediary to lend on the basis of debt. The extra cost of information generation, supervision and monitoring is to be considered an investment, which entails selection of superior projects and an efficient allocation of resources. The theoretical part of the chapter should not detain us long, as considerable discussion has already taken place on this issue and a good deal of literature has come out on financial intermediation and asymmetrical information. The importance of the chapter lies in its empirical evidence. The authors seem to accept and strive to verify the thesis that banks prefer fixed return instruments (FRIs) because they minimize the information requirement of a financial contract when the performance of the project is not observable by the financial institution, and that reduction of information asymmetry is a prerequisite for implementation of an equity-based system (or variable return instruments, VRIs). But this assertion is contested by the classical example of the used-car market. Informational asymmetry in the used-car market, being a one-time relation between the buyer and seller, is much more prone to moral hazard than an equity contract. But the fact that the market for used cars exists should be enough to prove that mere informational asymmetry could not be an obstacle in the way of equity-based contracts. It may be noted that the seller of a used car is absolved of any obligation if any defect is found in the car after the sale, whereas the bank's client will be held responsible if it is discovered that the loss is his fault.

Coming to the empirical part of the chapter, the authors argue that the ABI achieved symmetric information through investment in supervision and monitoring and expenditure on research and development. Due to overcoming the problem of moral hazard through information-sharing and monitoring, the share of equity participation *(musharakah)* in its portfolio increased substantially. They have attributed this to the decrease in the average number of steps and time that the ABI takes to conclude a contract, a relative increase in the share of *musharakah* over time, and to the composition of outstanding facilities extended to the non-public-sector by Islamic banks. I feel that the data given are not sufficient to substantiate the point that the authors wanted to make.

The authors have repeatedly emphasized that the ABI's investment in supervision and monitoring resulted in greater benefits. However, it is not clear what the volume of investment was for this purpose and as a result what benefits or returns it could derive. Had the authors shown the total costs in procurement of information and monitoring by ABI, and the resultant increase in its revenue, it would have been more convincing that these information costs were not a deadweight loss to society.

According to the authors, the major shift in the ABI's portfolio during the last 15 years was towards *musharakah,* because of eliminating the problems of chances of moral hazard. But it should be noted that out of the two equity-based contracts, *musharakah* and *mudarabah,* the former is the least vulnerable to moral hazard as in this case both partners contribute both capital and labour and the bank has a right to interfere. At a later stage the authors themselves accept that the shift in the ABI's portfolio towards an increased share of *musharakah* cannot be attributed solely to increased monitoring and supervision but also to a number of other factors. Had they argued that the increasing share of *mudarabah* (pure equity participation) was due to achievement of more symmetric information, their argument might have been more convincing. But the chapter is silent on any 'procedural change about *mudarabah* to save steps, time, and expense for the bank's partners'.

The chapter gives the impression that the dominance of mark-up and other fixed-return instruments in the early days of the ABI after implementation of the Interest Free Banking Law in 1983, and still in other commercial banks, has been due only to information asymmetry and fear of moral hazard. But that is probably not absolutely correct. It might have been due to their need for liquidity. The *mudarabah* and *musharakah* market is less liquid unless a secondary stock market also exists. Moreover, different Islamic instruments have their own characteristics and advantages. FRIs such as *murabahah, ijarah,* and *bay' al-salam* have an advantage over VRIs such as *mudarabah* and *musharakah,* because the former can be utilized for meeting end-use purposes such as household consumption needs, the purchase of durable goods, machinery, tools, equipment and the like, whereas the latter cannot. The authors consider moral hazard as an inevitable consequence of asymmetric information. Many studies have shown that this is effective only when principals and agents have a one-time relation. In a permanent and perpetual contract, with a competition for scarce capital, it will be eliminated. Similarly, a small or one man firm may capitalize on relative informational advantage. But this is less likely when a firm is a legal entity. It is for the same reason that moral hazard problems do not prevent people from depositing their savings with Islamic banks on a purely equity basis. It will be advisable to check whether there is any advantage from changing the condition of borrowers from small to big or from a one-time relation to a repetitive contractual relation in the changing capital structure of the ABI.

Another important factor that may eliminate the occurrence of moral hazard in spite of asymmetrical information is the prevalence of ethical values and moral commitments. If Islamic morality is fostered, the standard of expected behaviour will improve, covenants in the written contracts will be honoured, business records will be accurate, and monitoring costs will eventually fall. Thus, developments of equity contracts in the ABI may not be wholly due to investment in control and supervision. It may be, to a great extent, due to prevalence of ethical atmosphere.

If we allow for an honest world, the moral hazard problem, which introduces the deadweight cost in the variable return instruments, may be eliminated. The fact that ethical and moral changes in the society led to the increasing participation by the ABI is clear from the authors' own statement that even after destruction of all records in the Iraq-Iran War, the farmers themselves provided such records and 'all willingly submitted a copy of their own contracts to the bank ... from which their debt could be worked out and collected'.

The authors' claim that, along with investment in supervision and monitoring, the ABI also maintained a balanced and well-diversified portfolio encompassing a wide range of instruments. But Table 7.2 shows that more than two-thirds of capital was invested in *musharakah* and *mudarabah.* This cannot be considered to be a balanced portfolio. The other Islamic banks invested in ten types of instruments while the ABI was confined to seven. Interestingly, the instruments of *muzara`ah* (sharecropping), and *musaqah* (fruit sharing), especially for the agriculture sector, do not figure in the ABI's portfolio at all.