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## Islamic Finance: Debt versus equity An empirical Issue

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# Islamic finance: Debt versus equity: An empirical issue<sup>1</sup>

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## Abstract

*The current financial turmoil has led many writers in the area of Islamic finance to revive an old edict in Islamic finance – no risk, no gain. I have discussed this axiom in my earlier writings and have not come across anything in recent advocacy of its proponents that could make me change my position. Thus the object of this brief note is not to reopen that dialogue. In view of the theoretical heat that recent writings have generated, empiricists are prompted to test the hypothesis: Equity financing is better than reliance on debt for economic stability and growth, Muslim countries being the reference point. For this purpose, it is not difficult to select a sample and specify the relevant variables. But as growth in GDP is pivotal variable here the choice of production function for the work becomes important as there is a variety of frame works available. This note discusses the selection issue. More specifically, can we safely use a Model with technology remaining unchanged or it is imperative to have a dynamic framework?*

## Key words

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### 1. Introduction

In more recent years there has been a surge in writings on risk and its management in Islamic finance for a variety of reasons, the immediate one being the devastation the 2007 turmoil inflicted on financial institutions of all shades and categories, banks especially. The important factor among the causes of the crisis was the lure for leverage gains magnified by conversion of short-term finance into long-run financing tool via maturity transformation. Islamic banks suffered marginally for two reasons among others. They shun interest which dampens leveraging and they wrap all financial transactions around real assets. The volume of pure financial transactions is minimal and cannot balloon without parallel growth of real goods and services. This much is clear and not many will dispute.

The dissention was attracted when some respected scholars saw in the situation an opportunity of seeing mainstream interest finance as based on *solely* transferring risk to others and Islamic finance permissible *only* with risk sharing. Risk sharing promised both growth with stability and equity in distribution. This claim is difficult to defend in its 'solely' and 'only' aspects. This I have shown more than once. I have also argued that Islam's is a profit and loss sharing system; risk sharing being its consequence not the cause. Risk taking is a personal virtue. Society appreciates and encourages risk takers in general. However, moral evaluation should not be confused with economic valuation. In any case, the issue I want to raise here is different.

### 2. Equity versus debt – empirical evidence

There is a plethora of empirical work upholding that equity financing is inherently superior to reliance on debt financing not only for promoting stability and growth in an economy but for other

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<sup>1</sup> Author alone is responsible for the views expressed in this note. The same need not in any way be attributed to The Global University of Islamic Finance (INCEIF) where he currently works. Comments on the note are needed and can kindly be sent to the author on his E-mail address: [zubhasan@gmail.com](mailto:zubhasan@gmail.com) The author acknowledges the help of Nurhafiza Abdul Kader Malim, a PhD student at INCEIF she rendered in the revision of this Note.

reasons as well. Nevertheless, one way of being counted in the area of Islamic economics and finance is to restrict empirical work to Muslim countries, individual or the groupings like the OIC. Such work is doubtless useful in several ways but has limitations. For example, I do not expect results of a different import if we take a group of Muslim countries and another of non-Muslim countries other thing being equal and find significant difference in most of empirical comparisons.

However, one may attempt within a sample of Muslim countries to investigate if the use of more equity than debt tends to promote stability and growth. We may use panel data of banks including both Islamic and conventional and divide the sample vertically on the basis of average debt/equity ratio for the whole sample into groups with (i) low ratio i.e. below the average and (ii) those with high ratio i.e. above the average and see if this bifurcation gives significantly better results for the low debt banks. Note that countries cannot be divided as those having low/high ratios simply because both sorts of banks may and do exist in the same country.

Many problems concerning the data such as definitional uniformity or period coverage have to be resolved; adjustments and compromises may have to be made to overcome variable specification issues. Assuming that such hurdles have been reasonably overcome; a crucial decision this paper deals with remains. What production function framework we shall use?

### 3. Production function framework

Since growth of GDP is the dependent variable in the exercise and technological change obviously affect the level and rate of growth, one may argue that a dynamic framework such as used by Mankiw (1992) and after him by others is the obvious choice. But here, let us not lose sight of our hypothesis and objective. We are not interested in studying growth of the GDP per se and what numerous factors including foreign trade, capital inflows or exchange rate fluctuations for example impact it. Technological issues assume an ex ante air; it seeks to push scarcity frontiers forward. Equity-debt Issue uses ex post data; the study is essentially backward looking to draw inference for future course of action. A dynamic model focusing on technical change will not only fail to serve our purpose it will unmistakably drag us into unknown unwanted waters.

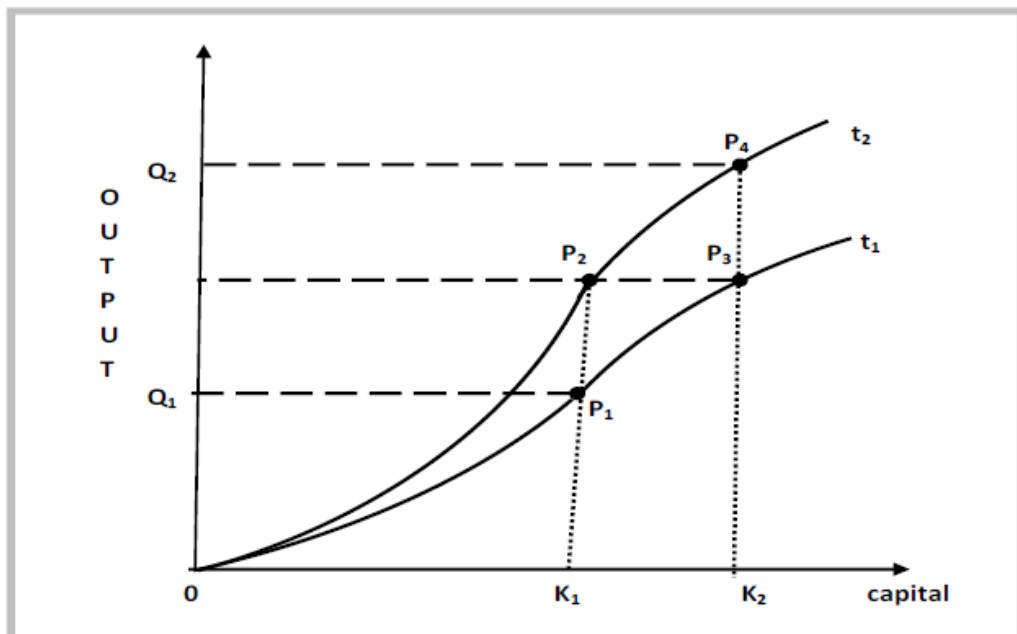


Figure 1: Production function & technology

Figure 1 above in the abstract may help us to understand the point. Here, each of the two curves  $t_1$  and  $t_2$  show levels of technology the higher one giving more output for the same capital and fixed labour input. Movement along any of the two curves informs us how returns to capital

in physical terms would change depending on the scale of operations. A movement from  $P_1$  to  $P_3$  or from  $P_2$  to  $P_4$  would keep us on the same curve with a given technology. We should better stay on either of the two for consistent results. In contrast, a movement from  $P_1$  to  $P_2$  or  $P_3$  to  $P_4$  takes us nowhere; where our data will belong to?

#### **4. Conclusion**

Thus, I believe that a functional framework with fixed technology is more appropriate and logical to study the equity-debt issue. I have used the framework in a section of a full paper on the subject and the results of the model are insightful. I shall be surer of my position if I could get confirmation about the adequacy of the production function employed.

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