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Debt, equity, universal banking and Islamic finance: A note

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Abstract. This brief note looks at the suggested use of universal banking as a tool to mitigating risk in financing operations' arising at both ends of the market – demand and supply. It concludes that the issue of adopting universal banking in the Islamic system is of little significance for risk reduction. It essentially raises the issue of mega banks versus smaller units in the Islamic system where the discretion would opt for the latter.
Keywords. Equity versus debt financing, Universal banking, Islamic finance.
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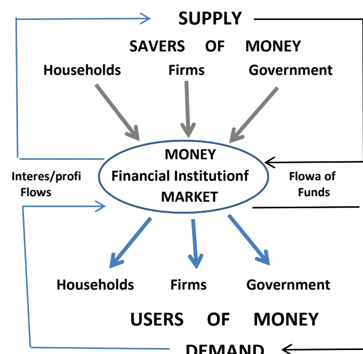
1. Introduction

In an economy, many business firms, governmental agencies and consumers are short of money they need for various uses while many others have surplus funds in the form of savings that they can supply for a return. These groups are non-exclusive; a fund user can also be a fund supplier. Financial institutions, dominantly the banks, operate as the intermediaries between the parties – they constitute the financial markets rendering the services for payment. This payment in business finance can be a fixed price – the rate of interest – or an expected rate of profit variable with the outcome of the venture. (See Figure below).The alternatives are known as debt and equity financing respectively. Much of the debate on financing modes centers on this broad bifurcation. The debt versus equity dialogue is of special interest to Islamic finance as it shuns giving and taking of interest. However, both modes of financing involve risk taking albeit of different sorts. Some scholars feel that adoption of universal banking can help the Islamic system to provide a counter check to mitigate these risks. For, Islam allows a time value for money in deferred payments. Here, we examine this proposition with reference to a *going* business concern seeking additional finance for expansion.



Let us start from the supply side of the market. Debt finance involves informational asymmetry. Those who opt for debt finance are better informed

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about how they would use the funds obtained than those who loan the funds. Thus, lenders like banks face the *risk of default*. In contrast, equity finance providers are exposed to *risk of loss* by investing in venture with results to be known in future. For the supplier of funds, the risk of losing money is real in either case. Thus, it is naïve to believe, as some do, that risk-sharing is the sole principle of Islamic finance while its conventional counterpart is completely free of risk-taking. Then, where is the difference? We examine the equity versus debt issue from in a duel market scenario where the In Islamic and mainstream financing institutions which operate in a competitive setting. A related question as to how the choice of either mode would affect the overall efficiency in an economy is ignored.[1]

2. Equity versus debt in financing

Equity financing implies that participants would share the profit or loss the contributed capital investment makes as per agreement with the firm. Loss sharing connects equity finance to risk. This connection has led to the dubious argumentation that risk sharing is the sole principle of Islamic finance. Contrary to claims, Islam never conceived of a financier's liability as being unlimited.[1] This plus *tawakal* must make the Muslim entrepreneurs exuberant, not averse to risk taking. Evidently, in equity financing the chance of losing money - the lemon problem - remains real and kicking. Participants share the risk of loss via the stock market trading. But in the absence of a benchmark referral like the rate of interest, risk taking could be a rudderless ship on high seas.

In the so-called non-risk debt finance the quality of information available on either side of the market assumes importance. The seekers of debt finance are better informed about the use of funds they obtain than its providers, mostly the banks. The information asymmetry generates the possibility of loss from the supply side due to default.

The, equity finance provider is exposed to risk of losing money in a sharing venture due to uncertainty of the future and in advancing debt, because of default arising from deficient information. Risk of losing money can be reduced. Default possibility in debt finance can be lessened through monitoring. However, monitoring of fund uses is a function of rising costs and cannot go full length. To meet such costs, banks may have to raise the loaning rates of interest. However, handling the risk of loss in equity finance is no less easy. To conduct and review the needed feasibility studies of projects too involve costs. And there is no a priori criterion to fix in which case the costs would be lower. Overall, debt is considered safer. On the demand side also, business firms, beyond a point, tend to prefer debt due to lower capital costs enabling leveraging gains and for leaving managerial control unshared (Razin *et al.,* 1998). Thus, debt proportions in business finance are fast on the rise. How can the risk of loss in either case, equity or debt can be mitigated? Many see the solution in *universal* banking.

3. Universal banking and risk management

Banking started to meet the short-term financing requirements of trade industry and commerce allowing checking and savings accounts. For the nature of their operations they got the name: commercial banks. With the passage of time, banks expanded their activities to increase their earnings and more than that to reduce risks they faced through diversification of their activities. These now extend from offering loans and accepting deposits to investing, asset management, issuance of credit cards, online money transfers, payment processing, handling of securities, underwriting, insurance, financing consumer durables from laptops to housing, currency trading and so on. Thus, individual banks have a wide variety of activities

[11] Timor Koran has mistakenly highlighted the absence of the limited liability provision in the Islamic law as one of the main factors arresting economic development in countries oblivious to the fact that in the centuries old classical *mudarabak* the financier could not lose more than the funds he commuted to the venture as it is in modern corporations. (On this see also Hasan, 2016).

to choose from subject to the regulation – domestic and international – they are obliged to observe.

This multifarious expansion of banking activities led to a new term coinage: universal banking is common in European countries, including Switzerland.[2] However, the most important feature of Universal Banking is its combining of short-term commercial activities with long-run investment operations. The World Bank explains:

> "In Universal Banking, large banks operate extensive network of branches, provide many different services, hold several claims on firms (including equity and debt) and participate directly in the Corporate Governance of firms that rely on the banks for funding or as insurance underwriters ".

The bigness of universal banks like Deutsche Bank, HSBC and ING gives them the advantage of more specialized and cheaper services; it invokes client confidence.[3] However, the same bigness with elaborate all-covering rules may scare and confuse them as well. With their monopolistic positions in the market they cater for big businesses. Their fall may shake the financial systems to their very foundations as happened in the wake of the 2007 turmoil beginning from the US. The country has since tightened regulations for universal banks.

However, let us confine here to an examination of the contention that combining the commercial and investment operations universal banking can work as an instrument for mitigating risk on both the demand and supply side of the market. More explicitly, the strategy for the bank is to take equity in a company and provide it with debt finance simultaneously. Let us begin with an examination how this strategy is expected to reduce risks of adverse selection and moral hazard the information asymmetry could create.

When equity and debt finance are simultaneously provided, the bank will have more access to information than when finance is limited to debt. Equity financing would facilitate continuous monitoring as the bank sitting on the board of directors would have free access to information the possibilities of moral hazard could be minimized. Firm's incentive to substitute riskier for safer assets is likely be dampened. At the same time, debt finance part would curb the firm incentives to conceal profits as more profitable firms get lower interest rates.

Empirical studies confirm the advantages of using a combination of debt and equity finance to both banks and firms. Such studies also confirm that universal banks face lower risk than commercial banks during both booms and busts phases of cyclical fluctuations. In view of such evidence, it is at times suggested that Islamic banks must increasingly adopt universal banking. We evaluate the efficacy of this suggestion in the following Section.

4. Universal banking and Islam

The plea for introducing universal banking in the Islamic financial system stems from the same mental captivation that finds ease in imitative adaptation of Western solutions to resolve all sorts of domestic problems not only in the case of science and technology but even in socio-economic fields. Move to universal banking must meet some conditions.

Central Banks invariably impose regulatory conditions for conversion of a common bank to universal banking institution. Some of such conditions are to be met before the grant of permission, following others remains under observation after the licensing. Some of these conditions, to illustrate, may relate to compliance with the cash reserve ratio and statutory liquidity ratio requirements, stoppage of certain activities now of after its conversion, disposal of any non-banking asset e.g.

[2] Universal Banking exists in many countries including America and many developing countries including India. Interestingly, China has a 'Universal Chinese Bank' operating in the US.

[3] Researches claim that universal banking reduced the cost of financing relative to countries with commercial banking, boosting her ahead of others in the industrialization race in pre-World-War-I Germany (Calomiris, 2000) and later in Japan as well (Nyankomo, 2015).

immovable property, however acquired, prior to conversion, abolition of floating charge on assets, if an. Restriction can be imposed on investment, composition of the board of directors, managerial remuneration, branch networking; lending priorities may be indicated (Jamal & Rathi 2006).

Universal banks have been popular in Germany, Switzerland, and other countries of Europe. In the Anglo-Saxon countries and Japan commercial and investment banking activities tend to be kept separated. In general they have restraint from adopting the European universal banking. In the U.S. the separation of the two operations faces resistance. Should Islamic banks go in the system? The question cannot be answered with a straightforward yes or no. For, most Islamic banks are not even at present specialized financial institutions doing only one or the other of the commercial or investment business; they combine elements of both to assume the appearance of universality. Also, it is not a matter of choice between the two – specialized or universal. Both exist and operate in parallel competing in many countries.[4] The debate on specialized versus universal banking system then boils down to an equity versus debt controversy in the Islamic finance. We have already discussed this issue and its off-shoots threadbare in some earlier writings. (See Hasan 2018).

5 Concluding remarks

The issue of universal versus specialized banking in the Islamic finance is not of much relevance with reference to risk mitigation; it eventually turns out to be a question of size – mega verses smaller banks. And the current state of Islamic finance the die is cast in favor of the latter. The asset size of most domestic Islamic banks is too small to assume universal banking operations. The regulatory framework is not also well developed for the purpose in most countries. Mega banks have not shown better immunity to turmoil. In fact it seems better to put your eggs in several smaller baskets than in a single big one. on Combining debt and equity under the same roof may pose compliance problems. It is the oaks that are uprooted in storms fast not the smaller plants. Managerial problems may crop up due to paucity of qualified professionals. Derivatives may gain ascendancy. Gharar and speculation may increase in transactions.

[4] Even as universal banks have expanded their operations in In both Germany and Switzerland, the smaller specialized institutions continue to remain entrenched in such areas as real estate lending, securities trading, and portfolio management suggesting that that universal banks do not enjoy a comparative advantage in all areas of banking.

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