

On the Efficiency of the Financial Institutions of Profit-and-Loss-Sharing

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Abstract. This note presents a few thought-provoking remarks on the efficiency and distributive implications of the institutions of venture capital that are based on profit-and-loss-sharing arrangements. Depending on the viability of incentive compatible mechanisms and optimal profit-and-risk-sharing contracts that minimize the asymmetric information and adverse selection problems these institutions may encounter in practice, they may well enhance allocative and dynamic efficiency.

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The conventional economic writings on ethically-inspired economic perspectives, such as those by Kuran (1986, 1989, 1993, 1995, 1996), Phillipp (1990) and Pryor (1985), reflect a skepticism about the creative depth, consistency and practicality of a particular Islamic ethical/economic discourse to inspire and produce efficient and effective solutions to the problems of modern economies. This skepticism is markedly evident in the criticisms that point out the failures of the theory and practice of this discourse in dealing with the urgent issues facing contemporary economies. The critical perspective the conventional economic works brings on the subject matter, however controversial it may be, raises important questions and provides substantive remarks on some unsettled issues and unresolved dilemmas associated with a certain ethical vision of economy. The works in question often touch upon many complex issues of practical significance, issues over which there are profound disagreements within the ethical discourse itself. We will reflect on

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one of these issues that has been the focal point of a rich and diverse spectrum of opinions, namely the issue of the so-called alternative banking, and make a few points on the efficiency and distributive implications of these controversial financial institutions that are based on the potentially promising idea of profit and loss sharing. We will attempt to avoid getting into the ideologically laden aspects of the issue, and focus mainly on some analytically tractable, positive aspects.

The presence of the financial institutions of profit and loss sharing within the financial systems of countries could be considered a potential source of allocative and dynamic efficiency. Judging from the actual record and experience, these institutions seem to have brought into the financial system a certain amount of previously "idle savings" in the hands of certain sections of society that have traditionally been uneasy and ambivalent in their dealings with the existing financial institutions that do not meet the normative criteria they deem important.¹ With their unique image and ethically/culturally sensitive rhetoric and practices that have proven to be attractive to the people of certain convictions who used to maintain most of their savings in the form of, for instance gold and other valuables, these institutions have been able to bring into the financial system new deposits (and hence, new "financial resources") some of which are channeled into "productive uses". The very function of bringing in and allocating previously idle resources to possible productive uses could be expected to contribute to the allocative efficiency of the economy and hence result in efficiency and welfare gains the measure of which deserves some theoretical and empirical research.

There is a potentially important efficiency-promoting feature of these institutions that has not yet played a significant role in practice. This is the feature embodied in the idea of financing promising investment projects through profit and loss sharing arrangements.² In sharp contrast with what the theoreticians had in mind, the amount of funds many of these institutions currently devote to the financing of such projects constitutes a rather

¹ A high ranking employee of one of these banks confirmed that some of their existing depositors used to maintain their savings in the form of certain "assets", such as gold, which were kept, predictably, outside of the conventional financial system (Buyukdeniz, (1996)).

² For a useful exposition of the fundamentals of venture capital, see Bartlett (1999), Long (2000) and Gladstone (1988).

insignificant percentage of their total assets.³ In an ironic twist, what is, in theory, one of the most distinctive features of these institutions turns out to be one of the least consequential ones in practice. This is, of course, not surprising in view of the asymmetric information and adverse selection problems they encounter in dealing with such investments.⁴ It is, however, exactly at this point where many innovative possibilities lie for the dynamic efficiency promoting prospects of these institutions. The challenge is to design incentive compatible mechanisms⁵ and optimal profit-and-risk-sharing contracts that minimize the problems in question so as to make profit-and-loss-sharing arrangements viable. If profit-sharing - whose success we think resides, to a considerable extent, in the microanalytics of such mechanisms and contracts - were to prove viable, it would serve as an alternative method to finance the feasible projects of "would-be" entrepreneurs who would not be able or willing to borrow at the financial terms of the conventional banks, and thus as such, with sufficient funds

³ The share of loans based on profit-and-loss-sharing in the total assets of many of the institutions that claim to provide an alternative to conventional banks is generally under 5 percent (Kuran(1995)). Thus, such institutions could not normally be considered ideal examples of profit-and-loss-sharing institutions.

⁴ For a variety of reasons, exemplified by Kuran (1995), the project undertakers (firms) may not reveal to the banks the full information about the true costs and revenues without which the banks, given their current financing methods, would not be able to make the project-specific financing decisions in an optimal manner. By virtue of such an asymmetry between the information possessed by the firms and the potentially inaccurate and partial information provided to the banks, the rational strategy for the banks is to be conservative about financing such projects. Moreover, as confirmed by the practitioners of alternative banking (Buyukdeniz (1996)), entrepreneurs with projects that have high expected returns tend to borrow from the conventional banks so as to maximize their profits, leaving, in part, the projects with low expected returns as prime candidates for profit-and-loss-sharing, which poses, for the alternative banks, what is called the "adverse selection problem" in the economic literature. However, the tendency of an entrepreneur to favor profit- and-loss-sharing need not always imply the infeasibility and low profitability of his/her projects. He/she may not be willing or able to borrow at the terms of the conventional banks because of his/her high degree of risk aversion or his/her inability to show collateral for the loan. A profit-sharing arrangement, if properly structured, could prove to be profitable to both parties in such cases.

⁵ An "incentive compatible mechanism" is a set of rules about a social process where the participants in the process would find it not to their advantage to violate the rules of the process (For a fairly detailed description and specific examples of incentive compatible mechanisms, see Eatwell, Milgate and Newman (1987, Vol.2: 739-743)).

devoted, it would facilitate the creation, in various sectors, of large numbers of firms that would be unlikely to come into existence under the conventional financing methods.⁶ The consequences of helping to bring about such a change in numbers of firms - which could vary in size, organizational complexity and the nature of engaged economic activity - on market structures, output, growth and distribution would not in general be unambiguously obvious and unconditionally certain. Robust conclusions on these consequences would require a comprehensive analysis of the relevant factors involved. Thus, in this context, we could only present some conjectures, the conditional validity of which could be established under some plausible set of assumptions: (1) Facilitating and accelerating the emergence, in a diverse range of economic activities, of large numbers of firms developing and producing new or improved products and processes, financial systems that include - in addition to the conventional banks - institutions providing widely available profit-sharing opportunities could help generate social welfare-maximizing growth rates that are higher than those under the conventional system, thus help promote the dynamic efficiency of the economy over time.⁷ (2) Facilitating a wider and "more dispersed" distribution of credit opportunities among entrepreneurs and would-be entrepreneurs, financial systems inclusive of profit-sharing options could help produce a "less concentrated" and thus more dispersed distribution of profits, which could, in turn, help induce a less unequal distribution of economic power and wealth. If the conditions under which these conjectures hold true are reasonably realistic - which we expect they are - they provide a good reason to undertake a careful study of the actual and possible profit-sharing practices so as to determine whether they could be assigned a role in designing optimal institutional frameworks within which markets generate efficient and normatively desirable distributive outcomes.

This note is not intended to make a clear-cut case for or against alternative economic institutions and practices, but to call for a careful and in-depth study of these practices that avoids the temptation to oversimplify the seemingly negligible and yet rather complex and potentially significant

⁶ For the role of venture capital in "the making of American Industries", see Doerflinger and Rivkin (1987).

⁷ Here we should mention the relevance of Cizakca's view on the subject (Cizakca (1993), which links the prospects of growth and development in the muslim world to the establishment of venture capital firms that finance innovative companies in return for some of their shares. In this context, the role venture capital has played in the development of capitalism in the West may also need to be pointed out. For an informative account of venture capital in Britain, America and Japan, see Clark (1987).

prospects of these newly emerging institutions in promoting certain economic outcomes with some desirable features of efficiency and distribution. Whether these institutions possess any innovative potential and prove to be efficient and viable alternatives (or "complements") to their existing counterparts, or simply degenerate into indistinguishably similar variations of them remains to be seen, but the creative impetus the controversy surrounding them seems to have given to the search for alternative institutions is worth a moment of reflection: Economists may need to pay greater attention to the insights and ideas drawn from non-conventional wisdom in designing new structures and institutions for a better functioning economy, regardless of whether the source of those ideas is Buddhism, Marxism, Poststructuralism or any other discourse that is at odds with the conventional economic theory.

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