

1. Introduction

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The Islamic financial system has a centuries-old history. As noted by Chapra and Khan (2000), 'From the very early stage in Islamic history, Muslims were able to establish a financial system without interest for mobilising resources to finance productive activities and consumer needs. The system worked quite effectively during the heyday of Islamic civilization and for centuries thereafter.' However, as the centre of economic gravity shifted over the centuries to the Western world, Western financial institutions (including banks) became dominant and the Islamic tradition remained dormant.

In recent years, however, there has been a significant revival of interest in developing a modern version of the historic Islamic financial system in the wake of Muslims' desire to stay clear of interest, which is prohibited according to the Islamic *Shari'ah*. Some countries (notably Iran, Pakistan and Sudan) are attempting complete elimination of the role of interest from their financial systems. Other countries have allowed the establishment of Islamic banks alongside what will be termed 'conventional' banks. There are now more than 200 Islamic financial institutions around the globe working under different economic and social milieux. Even in secular countries where legal systems do not allow establishment of Islamic banks, Muslim communities have found alternative provisions within the law to establish substitute institutions to fulfil the financial needs of Muslims in accordance with their faith. Bagsiraj (Chapter 9, this volume) offers a valuable survey of the experience of Islamic financial institutions in the secular system of India. He notes that although the financial laws of India do not allow establishment of Islamic banks, some Islamic financial institutions have been established as non-bank financial companies, which offer financial services without the use of interest. He provides instructive highlights of the working of several such institutions in India. Wilson (Chapter 10) reviews some similar institutions working in both Muslim and Western countries using non-bank provisions of the laws there. Recently, several Western multinational banks, including Citibank, Hong Kong and Shanghai Banking Corporation and Chase Manhattan, have also started offering Islamic financial products.

The Islamic financial industry is already one of the fastest-growing industries and has great potential. It has been estimated that the market size of Islamic

transactions was about \$160 billion in 1997 and was rising at an annual rate of 10–15 per cent (*Islamic Banker*, 1997). The re-emergence of Islamic banking and different types of Islamic financial institutions and products is to be welcomed because in many ways global financial arrangements can benefit from diversity and having banking institutions with a different *modus operandi*, and different risk-sharing characteristics associated with the types of contracts that they offer.

The papers at the Conference¹ (a selection of which are included in this volume) address some of the key analytical and practical issues in Islamic finance in general and banking in particular. Although, as mentioned above, Islamic banking has its roots in centuries-old history, formal analysis of Islamic finance is a comparatively recent phenomenon. Papers presented at the conference testify that it has developed significantly in a short period of time. There is richness in the analysis in the conference papers, which contributes substantially to enhancing our understanding of Islamic finance and its role in economy and society.

While the progress made by Islamic banks may be impressive, they should not be viewed in isolation. This could make them become marginalized. In this regard the contribution by Wilson (Chapter 10) is particularly welcome. In this chapter he considers, *inter alia*, how conventional banks can offer Islamic financing facilities, and whether or not Islamic and conventional banks are converging or becoming increasingly distinctive. He also considers whether Islamic banks can learn lessons from the experience of conventional banks and vice versa. In particular, he argues that conventional banks can learn useful lessons from the experience of Islamic banks with respect to developing more enduring and trusting relationships with their customers. His final conclusion, with which we fully concur, is that Islamic and conventional banks should not view each other as threats.

In order to set an analytical context to the wide variety of chapters in this volume, it is instructive to return to some first principles. In this Introduction, we review some of the key analytical issues that confront all financial systems. In particular, we consider the basic and universal functions of a financial system irrespective of its particular form, the nature of financial contracts, and the common problems encountered in all financial systems.

The functions of financial systems are universal, whether these relate to developed or less developed economies, or to Islamic or conventional economies. Similarly, the practical problems encountered in performing these functions are also common to all financial systems. Where different paradigms diverge, relates to precisely how the universal functions are performed (the different modes of finance, for instance) but more importantly to the mechanisms for solving the universal problems in practice. The latter relates

largely to the type of contracts issued. It is in these two dimensions that the key differences between Islamic and conventional finance lie.

1. UNIVERSAL FUNCTIONS OF A FINANCIAL SYSTEM

Four key roles are performed in a financial system. First, it provides financial intermediation services, channelling funds from ultimate savers to ultimate borrowers and in the process removing budget constraints. This in turn facilitates the movement of resources between agents, over time and across space. Second, the system provides a wide range of other financial services not immediately related to financial intermediation: payments services, insurance, fund management, and so on. Third, it creates a wide range of assets and liabilities, each of which has different characteristics with respect to, for instance, liquidity, maturity, the type of return generated, and risk-sharing. The fourth central role of any financial system is the creation of incentives for an efficient allocation of resources within an economy, and the allocation of scarce financial and real resources between competing ends. These key roles of the financial system are not specific to conventional or Islamic-based systems. It is in how these roles are performed that differences arise. This can be illustrated by giving some examples.

The function of financial intermediation requires providing mechanisms for saving and borrowing so that agents in the economy can alleviate budget constraints. This involves creating a variety of financial assets and liabilities with different characteristics that appeal to different savers and borrowers. The conventional commercial banks provide the financial intermediation services on the basis of rate of interest on both the assets and the liabilities side. Since interest is prohibited in Islam, Islamic banks have developed several other modes through which savings are mobilized and passed on to entrepreneurs, none of which involves interest. Yasseri (Chapter 8) describes several of these modes being used in Iran. These include *muḍārabah*, *mushārahah*, *murābahah*, *muzārahah*, *bayʿ al-salam*, and so on. Islamic banks in other countries are also, by and large, using the same modes, though the degree of use of a particular mode may differ from one bank to another. Similarly, for performing the function of providing other financial services, such as payment services, insurance, fund management and the like, Islamic banks have developed contracts such as *juʿālah*, *takāful* and *mushārahah*. Some of these are also discussed by Yasseri.

The third and fourth common functions require creation of a wide variety of instruments and incentives for an efficient allocation of scarce financial and real resources between competing ends. An efficient allocation of resources requires an accurate assessment and efficient pricing of risk. Somehow, the

price of finance needs to include an allowance for the risks involved. Similarly, the rates of return to the suppliers of finance should also reflect the risks taken. In conventional systems a major route for this is through the rate of interest, with risks of alternative projects or loans being reflected in different risk premia incorporated in interest rates on different loans. Clearly, this route is not relevant in Islamic finance, which means that alternative mechanisms are needed.

It must be noted here that the prohibition of interest in Islam does not mean that capital is not to be rewarded nor that risk is not to be priced. The Islamic system has both fixed and variable return modes to price the capital and add risk premia according to the degree of risk involved. Islamic banks provide financing using two methods. The first is based on profit-sharing and the second involves modes which depend on fixed return (mark-up) and often end in creating indebtedness of the party seeking finance. The modes of finance used by Islamic banks are, however, unique for two reasons. First, debt associated with financing by way of mark-up modes results from real commodity sale/purchase operations, rather than the exchange of money for interest-bearing debt. Unlike conventional debt, such debt is not marketable except at its nominal value. Second, the introduction into banking of modes that depend on profit-sharing is an innovation that brings important advantages. (See Mirakhor, 1997.)

2. NATURE OF FINANCIAL CONTRACTS

Financial instruments, contracts, institutions and markets are needed for these functions to be performed. Risk and uncertainty are at the centre of financial contracts and the way they are constructed. If there were no uncertainty about the future, the specific contractual form in which financial markets and institutions channel funds from savers to lenders would have no significance. The chapter by Suwailem (Chapter 2) discusses the problems of decision-making under uncertainty. He quotes from several authors to show that in conventional textbook presentations of decision-making under uncertainty, no distinction is made between investment and gambling. Chance and skill are treated equally in this framework. It is not clear how gambling differs from entrepreneurship, and why taking risk in some instances is praised and in others blamed. He argues that this framework is not suitable from an Islamic perspective. Instead, he suggests that the proper starting point for the subject is causality, whereby decisions are based on proper causes to achieve the desired outcome. The most likely outcome of a certain action determines its causal value, so if an action is more likely to lead to failure than to success, it is considered as a cause of failure, regardless of the desirability of the outcome. Because of the moral value of causes, the decision-maker shall not be deceived by the size of return when it is unlikely to materialize. Incorporating a moral value of cause, he argues

that from an Islamic perspective, decision-making under uncertainty requires implementing proper causes to achieve desired outcomes. Investment differs from gambling: investment is a decision to implement appropriate causes, while gambling is to take pure chance. The former is eulogized in Islam, while the latter is condemned.

In practice, uncertainty does matter and three alternative types of contracts are available to deal with it: debt, equity and insurance contracts. In comparing conventional and Islamic financial systems, the first two of these contracts have been the focus of several chapters in this volume. Debt contracts create a defined obligation to repay irrespective of the performance of the borrower. The rate of return paid by the borrower and received by the lender is independent of performance except in the extreme case of default. Equity contracts are where the return to the holder of the contract is determined by the performance of the issuer. The rate of return cannot be specified in advance, but is determined by the outcome of the project. As in the conventional system, both kinds of contract exist in the Islamic financial system. Relative preferences may, however, differ.

In conventional banking, debt has been found to be an efficient risk-sharing mode in the face of asymmetric information and when the costs of verifying the rate of return of a project become excessive in relation to potential benefits. At the same time, debt contracts minimize monitoring costs because the lending bank is not interested in the degree of success of the project so long as it does not fail to an extent that causes the borrower to default. Debt contracts also have lower transactions costs.

Due to these attractive features, conventional banks have a natural preference for debt contracts. However, the contract also has several undesirable features. One of these is that the bank does not share in the potential upside gain (the return is fixed even in the event that the project is extremely, and possibly unexpectedly, successful) but does share in the extreme downside potential loss in the event of bankruptcy of the borrower. For the financial system as a whole, it has been argued that excessive reliance on debt-financing is both inefficient and unstable. Analysing several financial crises, Chapra (Chapter 11) argues that the primary cause of these crises is inadequate market discipline resulting from debt-based borrowing and lending. He points out that:

Instead of making the depositors and the bankers share in the risks of business, it assures the depositors of the repayment of their deposits or loans with interest. This makes the depositors take little interest in the soundness of the financial institution. It also makes the banks rely on the crutches of the collateral to extend financing for practically any purpose, including speculation. The collateral cannot, however, be a substitute for a more careful evaluation of the project financed. This is because the value of the collateral can itself be impaired by the same factors that diminish the ability of the borrower to repay the loan. The ability of the market to impose the

required discipline is thus impaired, which leads to an unhealthy expansion in the overall volume of credit, to excessive leverage, and to living beyond means. (p. 221)

He poses the question as to why a rise in debt, and particularly short-term debt, should accentuate instability. In this respect, he points out that:

One of the major reasons is the close link between easy availability of credit, macro-economic imbalances, and financial instability. The easy availability of credit makes it possible for the public sector to have a high debt profile and for the private sector to live beyond its means and to have a high leverage. If the debt is not used productively, the ability to service the debt does not rise in proportion to the debt and leads to financial fragility and debt crises. The greater the reliance on short-term debt and the higher the leverage, the more severe the crises may be. This is because short-term debt is easily reversible as far as the lender is concerned, but repayment is difficult for the borrower if the amount is locked up in loss-making speculative assets or medium- and long-term investments with a long gestation period. (p. 222)

However, debt remains a useful contract both in conventional and Islamic systems. Chapra himself points out that 'there may be nothing basically wrong in a reasonable amount of short-term debt that is used for financing the purchase and sale of real goods and services.' The point here is that debt ought to be linked with real transactions and that it is not used for pure speculative purposes.

As compared to debt contracts, profit-sharing contracts are where the return to the holder of the contract is determined by the performance of the issuer. In contrast to a debt contract, the financier and entrepreneur share symmetrically (though not, of course, necessarily equally) in profits and losses. There are four key differences between the debt contracts and equity or equity-type contracts: the degree and form of risk-sharing; the absence of any ownership stake in debt contracts but its presence to some degree in equity contracts; the incentives that exist for the lender to monitor the borrower's post-contract behaviour; and the fact that default on debt contracts can trigger bankruptcy whereas poor performance on equity contracts does not trigger insolvency. Chapra argues (Chapter 11) that more equity financing would enhance the stability characteristics of financial systems because, through the resultant risk-sharing contracts, financiers would have a greater incentive both to assess risks at the outset and to monitor borrowers after finance had been given.

Theoretical studies in the early 1960s, which formed the basis for the establishment of Islamic banks, built their vision on profit-sharing finance. Several strong arguments in favour of profit-sharing finance over fixed return modes of finance were provided. However, in practice the modes of financing being used by most Islamic banks are dominated by fixed-return modes such as *murābahah* and leasing (see Iqbal et al., 1998). This divergence between theory and practice needs an explanation. Several chapters in this volume address this issue.

There are practical reasons for the profit/loss-sharing (PLS) contracts not to be as popular as expected. Problems of moral hazard, adverse selection, high information requirements and higher transactions costs are some of these. Abalkhail and Presley (Chapter 6) note that constraints on PLS contracts in Islamic banking derive essentially from problems of asymmetric information and the nature of banks as essentially short-term finance institutions. Similarly, Ahmed (Chapter 3) highlights the moral hazard problems in PLS contracts. In order for Islamic finance to deliver its full promise, the share of profit-sharing finance in the financial system must be increased. However, in order for this to happen the features of a profit-sharing contract which are compatible with the incentive requirements of both suppliers and seekers of funds must be identified and incorporated in the contracts. Some authors in this volume argue that while equity or equity-type contracts are to be preferred in Islamic finance, there are major obstacles in the way of their widespread use. They have pointed out several problems along with possible solutions. Some of these are discussed below.

3. COMMON PROBLEMS

Just as the role and basic functions of financial systems are universal, so too are the problems that are encountered in performing these functions. However, there are differences in the way they are handled. Many chapters in this volume focus on the ways of addressing these problems in Islamic finance. It is instructive to outline the nature of at least the most important of the common problems. A brief consideration is given to six problem areas that are discussed in different chapters included in this volume: (1) the problem of asymmetric information and the costs involved in reducing it; (2) the problem of verifying, *ex ante*, the promises and intentions that are frequently involved in financial transactions (adverse selection problem); (3) problems of moral hazard; (4) incentive problems and the issue of aligning incentives between counterparties; (5) agency costs when direct or indirect principal–agent relationships arise in financial transactions; and (6) the need for monitoring of counterparties' behaviour.

3.1 Asymmetric Information

Information is at the centre of all financial transactions and contracts. Three problems are pertinent: not everyone has the same information; everyone has less than perfect information; and some transactors have 'inside' information which is not made available to counterparties to transactions. Decisions are therefore made *ex ante* on the basis of less than complete information and sometimes with counterparties who have superior information with the potential

for exploitation. In any financial system, information is not symmetrically distributed across all agents, which implies that different agents have different information sets. Put another way, full and complete information is not uniformly available to all interested parties. In addition, not all parties have the same ability to utilize the information that is available to them. In particular, parties have more information about themselves (including their intentions and abilities) than do others. The problem arises because information is not a free good and the acquisition of information is not a costless activity. If either were the case, there would never be a problem of asymmetric information. Information problems have been addressed in many of the chapters included in this volume. This is not particularly surprising, as asymmetric information and the problems this gives rise to are central to financial arrangements and the way financial institutions behave to limit and manage risk.

One general solution to information problems, of course, is for transactors to invest in information, although, as already noted, this is not a costless activity and free-rider problems may emerge as, in some cases, no one transactor can appropriate the full value of the costly information acquired. However, in some areas public policy can assist by requiring disclosure of relevant information. Ahmed (Chapter 3) emphasizes the role that governments can play in alleviating asymmetric information problems in Islamic finance by requiring information disclosure. He also observes that information disclosure, along with other measures that governments can adopt, is required not only to bolster profit-sharing modes of finance but also in the interests of efficiency in the financial system in general. There are also international standards of information disclosure set by the Basel Accords. These need to be given serious attention.

Markets can also sometimes create incentives for disclosure as, for instance, when the cost of capital is lowered when complete information is made available to market participants. It is also an option to screen counterparties and attempt to verify the information given. And yet none of this is costless, which implies that the rational transactor will continue to acquire information until the marginal cost of acquisition is equal to the marginal benefit derived from it. This is easy to state in principle but difficult to measure in practice. A key question, therefore, in many financial transactions (most especially in loan arrangements) is what information is necessary before a considered judgement about risks can be made.

Abalkhail and Presley (Chapter 6) remind us that, without effective information transfer, markets perform poorly and inefficiently. A somewhat different, but very useful, perspective is offered in their chapter, where they discuss asymmetric information problems in PLS contracts in the informal risk capital market of Saudi Arabia. They present empirical evidence with respect to how attempts are made to solve these problems in this particular market. The chapter

presents the first-ever empirical investigation in Saudi Arabia of informal investors' decision-making behaviour. The authors present a theoretical framework, based on asymmetric information, principal–agent analysis, and incomplete contracts that characterize this market. They use this framework to test empirically how informal investors attempt to reduce the inefficiencies and risks associated with asymmetric information problems that exist in PLS contracts.

3.2 Contractual Promises and Adverse Selection Problem

Financial transactions often involve a set of promises or undertakings from one party to another. The problem is that intentions cannot be observed and there may be incentives to lie to or mislead a counterparty. For example, in the case of PLS contracts, Ahmed (Chapter 3) points out that 'as the profit is shared between the firm and the bank at an agreed-upon ratio, there may be an incentive on the part of an amoral entrepreneur to report lower profit to keep a larger share of it for himself'. He then goes on to give a theoretical exposition of a profit-sharing contract that may reduce the inducement to cheat through a reward/punishment mechanism. The fact that intentions cannot be observed in essence implies that financial contracts are necessarily incomplete contracts. As argued by Abalkhail and Presley (Chapter 6), this implies that 'investors may be unable to predict future events in order to write complete contracts that specify each party's obligations in all contingencies'. The central problem is how one party can ensure that the counterparty delivers on promises or intentions. This may involve sanctions or creating incentive structures that align the interests of the counterparties. This is discussed in section 3.4 below.

3.3 Moral Hazard Problems

Moral hazard is a particular incentive problem that often arises from asymmetric information. Superior information may enable one party to work against the interest of another. In general, moral hazard arises when a contract or financial arrangement creates incentives for parties to behave against the interest of others. The skill in devising financial contracts is to limit the potential for moral hazard behaviour.

There are inherent moral hazards in profit-sharing contracts, which is one reason for their lack of popularity even in Islamic banks. One problem, for example, is the incentive the borrower may have in concealing the true level of profits or absorbing some of the profits through unauthorized perquisites. However, these problems are not unique to profit-sharing contracts. They are similar to those that arise in any equity contract in conventional systems.

The solution to moral hazard problems can lie in a combination of incentive-compatible contracts, the imposition of penalties on bad behaviour, effective monitoring of behaviour, and the enforcement of contracts if ever a moral hazard arises which creates an incentive for one party not to deliver on a contract. One solution in conventional banking, which may have only limited use in Islamic banking, is the pledging of collateral against loans whereby the borrower loses the collateral in the event of default.² This is a mechanism for aligning the incentives of the borrower with the interest of the lender.

In the Islamic system a particular consideration is the extent to which reliance can be placed on good behaviour dictated by the norms of Islam itself. This is an interesting area and useful discussion is given in the chapter by Wilson (Chapter 10). He argues that there is a higher level of trust between Islamic banks and their clients than is the case with conventional banks and hence the moral hazard risks are less. This is because there is a greater degree of shared values, including ethical values related to honesty. He makes the important point that higher levels of trust reduce risk and uncertainty, which in turn results in lower monitoring costs for Islamic banks. A similar line is offered in the chapter by Khalil, Rickwood and Murinde (Chapter 4), who argue that 'religion, and in particular Islam, demands specific codes of behaviour to be followed, adherence to which would reduce the agency problems'.

3.4 Incentive Structures

A key problem in many financial transactions is how to create incentives for good behaviour, and in particular incentives not to behave against the interests of a counterparty in a transaction. A central issue in any financial system is the structure of incentives that arise and how contracts can be constructed in such a way as to align incentives. Some of the chapters discuss a particular route to solving incentive problems: the creation of incentive-compatible contracts. These are extensively discussed in the literature in conventional finance. The key is to construct contracts that align the incentives of counterparties. Obvious mechanisms include profit- or reward-sharing arrangements, imposing costs and penalties on bad behaviour, and ensuring that contracts are enforced and that all parties know that contracts will be enforced. The chapter by Karim (Chapter 5) considers optimal contracts to deal with the problems of asymmetric information and the resultant danger of moral hazard and how risk-sharing can be structured optimally. He emphasizes the requirement to construct incentive-compatible contracts for Islamic banking and, using a valuable case study of Bank Muamalat, Indonesia, proceeds to describe how this can be done. He stresses four conditions for incentive-compatibility in contracts: the entrepreneur or recipients of funds having a higher stake in net worth and/or collateral; low operating costs; having a low degree of unobservable cash flow; and having

a low proportion of non-controllable costs. He discusses the nature of optimal contracts and, using the case study of Bank Muamalat in its *muḍārabah* contracts, shows how the proportion of profit-sharing financing increased significantly after 1998 when the bank introduced its pilot project based on incentive-compatible contracts for profit-sharing modes of finance. This chapter is particularly interesting because it extends the analysis beyond the theoretical plane and illustrates a practical application of theoretical constructs.

The literature on this topic as related to conventional finance also includes reference to reputation as at least a partial solution to incentive problems. This becomes relevant in repeat games where a bad reputation gained in one contract is carried through to subsequent contracts, which means that the terms of subsequent contracts are less advantageous and sometimes contracts are refused altogether. Abalkhail and Presley (Chapter 6) discuss how the investors in the informal sector evaluate the reputation of the entrepreneur through consultation with other investors. They find that for Saudi informal investors the track record of the entrepreneur is the best method of preventing the selection of low-quality entrepreneurs. This may have important lessons for Islamic banks. They can institute a mechanism through which amoral entrepreneurs are singled out and blacklisted by all banks.

3.5 Principal–Agent Problems

Financial transactions frequently create principal–agent problems of one sort or another. This is also related to the problem of incentive structures in that the central issue is how a principal is able to rely on the agent acting in the interests of the principal employing him rather than his own selfish interest and against those of the principal. The problem arises because the agent often has superior information and expertise (which may be the reason the principal employs him). The agent can choose his behaviour after the contract has been established, and because of this the agent is often able to conceal the outcome of a contract. Agency problems also arise because the agent cannot be efficiently or costlessly monitored. Unless these problems can be solved, the agency costs involved can act as a serious deterrent to financial contracting with resultant welfare losses. The challenge is to create contracts or arrangements that align the interests of the principal and the agent. As many of the authors establish, one way of solving this is through a standard profit/loss-sharing arrangement whereby the agent shares the profits with the principal and so has an incentive also to behave in the interest of the principal.

Abalkhail and Presley (Chapter 6) remind us that the literature has identified two main approaches to reducing agency problems. In the principal–agent approach, the focus is on the optimal contract between principal and agent. In contrast, in the incomplete contract approach emphasis is given to how contracts

can be made less incomplete. The particular agency costs associated with *muḍārabah* contracts are discussed by Khalil, Rickwood and Murinde (Chapter 4), who present substantial empirical evidence on the problems encountered in such contracts. The authors have applied survey methods to collect primary data on the practice of Islamic banking and in the process have produced what is probably one of the most comprehensive empirical tests of PLS contracts to date. The authors extensively consider the agency characteristics and problems in PLS contracts such as overconsumption of perquisites by the entrepreneur, the under-reporting of profits, risk avoidance and shirking of effort by the agent. They go on to propose a robust contractual governance structure to cope with the agency problems encountered in PLS contracts.

3.6 Monitoring

The need for post-contract monitoring is generally greater in finance than in other areas of economic activity. Because of the asymmetric information problems, the behaviour of counterparties needs to be monitored after a contract has been agreed to ensure that information asymmetries are not exploited by one party against the interest of the other, and also because frequently a fiduciary relationship is created by a financial contract. In both cases, agents need to be monitored to ensure that their behaviour is consistent with the interests of principals. A special characteristic of many financial contracts is that the value cannot be observed or verified at the point of purchase, and that the post-contract behaviour of a counterparty determines the ultimate value of the contract. This also creates a need for monitoring. In addition, monitoring is needed because many financial contracts are long-term in nature and information acquired before a contract is agreed may become irrelevant during the course of the contract as circumstances and conditions change. Above all, the value of a contract or financial product cannot be ascertained with certainty at the point the contract is made or the product is purchased. This often distinguishes financial contracts from other economic contracts such as purchases of goods. While the need for monitoring is accepted, it too is an expensive activity (see Khalil, Rickwood and Murinde, Chapter 4) and transactors need to balance the marginal costs and benefits of incremental monitoring.

An interesting way of safeguarding against the asymmetry of information at the post-investment stage is staging of finance. Abalkhail and Presley (Chapter 6) show how informal investors resort to this method to minimize adverse selection. Another way is supervision and monitoring of the entrepreneur. In their chapter (Chapter 7), Sadr and Iqbal show the importance of returns to information-gathering and monitoring of recipients of funds and entrepreneurs in order to reduce asymmetric information and resultant moral hazard problems. They provide a useful case study of the Agricultural Bank of Iran and show

that there are huge benefits for an Islamic financial institution investing in supervision and monitoring.

4. CONCLUSION

Several potential benefits can arise from the emergence of Islamic banks, beside their desirability from an Islamic point of view. These include:

1. The range of contracts available to customers is widened. This is an example of the efficiency-enhancing characteristics of spectrum filling (Llewellyn, 1992).
2. It would create a financial system populated by financial institutions with a different *modus operandi*, which has the effect of widening choice for consumers.
3. The widening of the range of financial contracts available, and differences in the *modus operandi* of conventional and Islamic banks, have the effect of enhancing competition between alternative banking models which is expected, in turn, to increase efficiency of the financial system.
4. It would enable Islamic religious beliefs to be reflected in financial arrangements and transactions, thereby fulfilling the financial needs of Muslims in accordance with their faith.
5. Allocation of financial resources on the basis of profit/loss-sharing gives maximum weight to the profitability of investment, whereas an interest-based allocation gives it to creditworthiness. We may expect the allocation made on the basis of profitability to be more efficient than that made on the basis of interest.
6. Because of the nature of the contracts on the liabilities side of the balance sheet, Islamic banks are often less vulnerable to external shocks and are less susceptible to insolvency. This is because a wider range of liability holders share in the risks of the bank as compared with the conventional banks.
7. Because holders of investment deposits share in the risks of an Islamic bank (for example through PLS contracts) and are not offered guarantees, incentives are created for a wider range of stakeholders in the bank to monitor its behaviour and risk-taking.
8. By creating more systemic diversity, the stability of the financial system may be enhanced because the behavioural characteristics of different types of banks are likely to vary.
9. In the case of both the PLS and *murābahah* contracts, since bank assets are created in response to investment opportunities in the real sector of the economy, the real factors related to the production of goods and services (in

contrast with the financial factors) become the prime movers of the rates of return to the financial sector.

During the last two decades, the Islamic financial industry as well as the Islamic theory of finance has made significant progress. However, as an evolving reality the industry is still faced with many problems. Some of these have been noted by the contributors to this volume. Islamic finance as a discipline is also in its early phases of development. A number of theoretical issues need to be researched. One of the most important issues that captured the attention of several contributors to the conference relates to the role of profit/loss-sharing under Islamic finance. Despite several theoretical studies showing the benefits of profit-sharing, in practice it has not been adopted by Islamic banks to any significant degree. Contributors to this volume have mentioned some reasons for this divergence between theory and practice. The attention given to this issue is very welcome. An important area in the development of the Islamic theory of finance is to identify the features of a profit-sharing contract that are compatible with the incentive requirements of both suppliers and seekers of funds. Therefore, a great deal more research is needed in this area.

NOTES

1. The Fourth International Conference on Islamic Economics and Banking, Loughborough University, UK, 13–15 August 2000.
2. In the Islamic system, such recourse is possible only in the case of default or loss caused by negligence or wilful misconduct.

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