Chapter 8

TOWARDS A CONTRACTUAL MODEL OF PROFIT-LOSS-SHARING

8.1 INTRODUCTION

We noticed in chapter two that the theory of the PLS assumes availability of full and equal information about actual profits to depositors, banks and entrepreneurs. Given this information each group asks for a minimum p/s ratio acceptable to it. As the central mechanism underlying the PLS system is the p/s ratio rather than the rate of profit, the model does ignore the possibility of losses. The existence or non-existence of an expected positive rate of profits (a positive NPV investment opportunity) determines the existence or non-existence of a PLS contract. On an *ax ante* basis, the PLS contract exists, because the expected profits of the underlying projects are not only positive but are also superior compared to competing opportunities. Thus there is only one possibility to start with a PLS project, i.e., a positive NPV investment opportunity. This consideration is so central to the model that Siddiqi explicitly emphasizes the point that banks as prudential institutions will almost ensure positive profits.

For defining the p/s ratio the assumption of a positive rate of profit is needed. However, as for the case of the PLS as an alternative to the interest mechanism is concerned, there are practical difficulties inherent in the PLS itself, which we discussed in previous chapters of this work. The objective of the present chapter is to recapitulate these inherent limitations of the PLS. The chapter also aims at summarizing and formalizing the proposed reform in the PLS mechanism.
8.2 A BASIC LIMITATION OF THE P.L.S. MODEL

The PLS is based on the concept of Islamic financial contracts, particularly, the MM. The MM are firm level arrangements. However, the PLS model derived from the MM contracts does not emphasize the firm level behavioral considerations. The model instead is more suitable to deal with the closed economy macro-monetary system. A monetary model does not require to be based on behavioral considerations. Therefore, most criticisms of the PLS are launched from the contractual and behavioral premises.

In the previous chapters we argued for changes in the PLS from a number of aspects. Fundamentally, the PLS should mold to meet the requirements of firms rather than asking them to confirm to its given structure. The most crucial implication of this consideration is in the area of ownership structure of firms. Considerations related to ownership structures are equally relevant within a firm in a closed or open economy and between foreign and local parties in an open economy context.

We reported that at least two studies, namely, Ahmad (1990) for Sudan (which is a capital scare economy) and al Hajjar and Presley (1996) for Saudi Arabia (which is a capital rich economy) found that firms do not like to use the MM arrangements. The brief explanations in both the two cases is related to considerations for ownership structures. The two researchers asked their respondents: “Do you prefer the MM modes of finance?” We argued that the MM are more than modes of finance; these are in fact forms of enterprises. So strictly speaking, the implication of the question asked is, “If you need finance, will you prefer to change the ownership structure of your sole proprietorship enterprise and become a partnership in case of musharakah, or close your business and work as an agent in case of mudarabah?”

The central issue is therefore that, in the PLS, the availability of finance is conditional to the change in the firm’s longer-run ownership structure. From the firm’s perspective, this is a crucial behavioral consideration which the PLS model totally disregards.
8.2.1 A Proposed Reform in the PLS

The PLS can be re-structured and vitalized by incorporating the ignored behavioral consideration. By disregarding this consideration, the PLS has confronted the typical principal-agent problem. In a principal-agent relationship, the allegiance of the agent to the contract depends on whether cooperation or non-cooperation is more financially rewarding. If non-cooperation is rewarding, the agent will behave dishonestly. Consequently, the efficiency of an enterprise characterized by an principal-agent relationship largely depends on the implicit or explicit incentive mechanisms underlying the contracts.

We take up *muḍarabah* as a pure financial contract based on sharing - a contract in which the financier owns the project but the entrepreneur manages it and the outcome is shared by the two and the entrepreneur controls all the information related to the operational results of the enterprise. The entrepreneur could have an incentive to report the enterprise as inefficient and keep for himself a larger proportion of the project's outcome\(^1\). In a cross-country scenario the problem will be aggravated by many other considerations. Thus, from the perspective of the principal, efficiency of the enterprise is also restricted to the reporting by the agent in addition to its actual operational performance.

Some researchers argue that, for two reasons the above situation will not arise in an Islamic economy. Firstly, Muslims believe in the eternal concept of life, in which honesty is rewardable and dishonesty punishable. This is a non-material incentive for people to be honest. Secondly, if all financial operations are based on sharing (and a continuing rather than one time relationship is developed between financiers and entrepreneurs), honest entrepreneurs will force dishonest entrepreneurs out of the market. So there is also a financial incentive for being honest\(^2\).

**Strengthening Incentive Systems**

The behavior of the entrepreneur could be checked by the principal by monitoring which could become too costly to be feasible. The other way to counter dishonest agent behavior is to design contracts in which honesty rather than dishonesty is rewarding.
Both the financial and non-financial incentives for cooperative and honest behavior mentioned above are implicit in the general framework of the Islamic economy. These are not contract specific. Therefore, by introducing certain contract specific incentive mechanisms, cooperative and honest rather than non cooperative and dishonest behavior can be made more rewarding.

But the incorporation of incentive systems in contracts is often difficult. However, one strong incentive for cooperative behavior, which could also be feasible to incorporate in the sharing contract, is the transfer of ownership of the project to the agent within a known time period. By linking the transfer of ownership with the declaration of profits, the agent can be prompted to declare higher profits.

To put the affect of this incentive mechanism on efficiency into sharp focus, two PLS contracts can be compared. In the first case, the principal perpetually holds the ownership of the projects as under the MM. In the second case, the contract ensures that the ownership of the project will be transferred to the agent after completion of certain payment. It is obvious that in the latter case, to complete the payment and get ownership, a rational entrepreneur will not only report honestly but would also work harder. This is not the situation in the previous case. Thus, it could be suggested that incorporation of the provision of sale of investment in the PLS contract may offer a very strong incentive for cooperative and honest behavior and incorporate efficiency elements in the PLS.

Incentives in Mark-up vis-à-vis Sharing

In international investments as soon as a sale element is incorporated in the sharing contract, the principal-agent positions are reversed. As the supply of finance, technology, and R&D intensive services is made on the order of the domestic public or private parties, these parties assume the role of the principal. Whereas the supplier, being working on their behalf acts as an agent.

In such a situation, the incentive structure underlying a particular contract will depend on the relative importance of the pricing and sharing elements. If the pricing element is overwhelming (i.e., if a pure deferred sale is adopted), the supplier may be prompted to
maximize his profit by saving on quality; sub-standard equipment and methods may be supplied. But the observation of the behavior of some multinational companies suggests that in order to expand sales and control markets, these companies sell high quality resources at a low profit margin. Nevertheless, generally speaking, the risk of receiving low quality of resources will be high if the importing country is less developed and the objective of the transaction is the import of technology as in offsets, turnkey projects etc.

To the extent that the pricing mechanism is replaceable by the sharing mechanism, an incentive system can be developed to promote the importation of highly quality resources. This is because, under the sharing arrangement, the agent will have an incentive to supply good quality of resources with which higher output can be generated and shared.

The choice between a sharing and a pricing arrangement will depend on the objectives of the import policy. If transfer of technology is the main objective of the import of resources, then pricing arrangements will become inevitable. On the other hand if maximization of national output is the prime objective of the import policy, the sharing arrangement would become more relevant.

Transfer of technology and maximization of national output may not be conflicting objectives. However, the quantity of output to be produced by the imported resources can be verified in a relatively short period of time. Whereas, the quality of the imported technology can only be verified in the longer run.

Therefore, it may be appropriate for many developing countries to postpone their emotional considerations for technology transfer to the future and design contracts with foreigners for the maximization of present revenues. Once the resource-base of these countries is developed by increased productivity and as a result reasonable R&D expenditures are forthcoming, they can also be in a position to evaluate the technological component of the import of foreign resources. This implies that, for some time, some developing countries should give priority to pursue acquisition of projects on the basis of profit or output sharing instead of pure installment purchase.
Accordingly, an agreement will be reached by a host and foreign party for establishment of a joint venture project in the host country according to the specifications of the host. The host party will gradually and systematically purchase the ownership share of the foreign party out of his shares in the profits or output of the project. As national resources will not be permanently owned by foreign investors, this will alleviate the sentimental rhetoric against foreign control and its adverse effects on the investment climate.

Incentive Structures in Gross and Net Income Sharing

Output and profit sharing arrangements could be interchangeable and can be alternatively utilized in different circumstances. In this regard, some points about the suitability of output sharing are worth mentioning.

First, in the process of international resource transfer, due to the dominance of sovereign influence on the part of the principal, especial risks are confronted by the foreign investors. The most important of these are the transfer risks e.g., changes in economic conditions and policies adverse to foreign exchange earning and payment of profit services.

In many cases, these risks can be managed better by adopting an output rather than profit sharing strategy. For example, in profit sharing, profits are calculated in the local currency and then the foreigner's share is remitted in foreign exchange. During the period of production, sale and profit remittances, exchange rate and exchange control policies may become adverse to the foreign investors. Output sharing is resistant to such risks as currency conversion process can be avoided.

Second, the general perception is that the incentive mechanism of profit sharing makes it more efficient therefore, preferable compared to output sharing\(^3\). However, this may not always be the case.

In Table 8(a) different cost scenarios have been presented facing four foreign projects A, B, C, & D. These projects are established on order of the host country which is their ultimate owner. Therefore, the host country assumes the role of the principal. However, since the foreign suppliers of these projects work on order, they play an entrepreneurial role.
Table 8 (a): Efficiency Considerations in Net and Gross Income Sharing

<table>
<thead>
<tr>
<th>Entrepreneurs</th>
<th>Gross Income</th>
<th>Variable Cost</th>
<th>Net Income</th>
<th>Share of Principal in Gross Income %</th>
<th>Share of Principal in Net Income %</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>100</td>
<td>0</td>
<td>100</td>
<td>50</td>
<td>50</td>
</tr>
<tr>
<td>B</td>
<td>100</td>
<td>5</td>
<td>95</td>
<td>50</td>
<td>52</td>
</tr>
<tr>
<td>C</td>
<td>100</td>
<td>10</td>
<td>90</td>
<td>50</td>
<td>55</td>
</tr>
<tr>
<td>D</td>
<td>100</td>
<td>15</td>
<td>85</td>
<td>50</td>
<td>58</td>
</tr>
</tbody>
</table>

Assuming that the gross income (output) sharing ratio between the foreign investors in the four projects and the principal (i.e., the host country) is 50:50. The hypothetical data of Table 8(a) shows that investors in all the four projects, irrespective of cost structures of their respective firms, pay equal proportion of gross income as shares to the principal. But as a percentage of net income (profit), the inefficient agents pay more shares compared to the efficient agents. Since, for the determination of the enterprise's profitability, net income is more relevant, the incentive structure underlying gross income sharing crystallizes the cost of inefficiency. Therefore, profit maximizing agents will see the indication that gross income sharing actually works as a tax on inefficiency.

Third, in output sharing compared to profit sharing limited variables need to be monitored, therefore, monitoring the cost would be much easier and

Finally, since the shares of the project in question in a particular time will be sold at the prices prevailing then, efficient projects will fetch more sale revenues compared to inefficient projects. This fact would also work another important incentive factor for the foreign entrepreneur /investor to provide good quality of resources.

8.2.2 A Model Of Redeemable Profit and Loss Sharing

We assume that the firm is interested in the acquisition of independent ownership. This assumption is reminiscent of the Islamic and nationalist sentiments in Muslim countries against foreign control as well as owner-managers’ preferences as indicated in Ahmad (1990) and al Hajjar and Presley (1996). Moreover, it is conforming with the ethos of owner operated enterprises which seek funds for growth financing. It is also consistent with the reviving traditional theory of finance according to which firms prefer debt finance due to its redeeming nature and harmony with internal ownership. It is also compatible with the
problem at hand: Firms desiring and being able of issuing equities will go ahead with the PLS. *The problem is with the provision of that part of the needed funds for which firms are not able or willing to issue equities or offer PLS contracts.*

We also assume that an entrepreneur unlike a typical manager prefers to invest his savings in the growth of his own enterprise rather than keeping these savings outside. If he keeps his savings outside, it means that those outside investment opportunities are superior to his enterprise and it will adversely reflect on his own efficiency. However, in the initial stages of the enterprise, the entrepreneur prefers some risk-sharing arrangement as it spreads the risk. Therefore, the promotive role of an Islamic financial institution is essential due to an infant entrepreneur's attitude towards risk. Gradual acquisition of ownership is expected to improve entrepreneurial risk profile. Redeemable PLS encourages entrepreneurial initiatives and ensures a systematic process for their promotion.

We assume that a redeemable PLS enterprise starts operation with a capital contribution by the entrepreneur equal to an amount B, and a capital contribution by the financier equal to an amount K. Compared to K, B is a small amount. Hence, K can be re-written as $K = NB$; N being a real number. Consequently, the project needs $B + K = B + NB = (1+N)B$ amount of capital in each period.

With respect to profits and re-invested profits, we consider two cases. The first case represents a hypothetical case of a project which yields a constant stream of periodically (yearly) calculated profits. The second case the profit yields are assumed to be different in different reporting periods.

**Constant Stream Of Profits**

We assume that the project yields profits equal to $P_1$ for all periods. In period $t_1$, the entrepreneur's share in profits would be

$$Sh_t = \frac{P_1}{N + 1}$$ and
Similarly, if the joint nature of the enterprise is contractually agreed for 6 years, the
share of the entrepreneur in profits in period \( t \) can be written as

\[
Sh_t = \frac{P_t}{N+1} \left\{ 1 + \frac{P_t}{(N+1)B} + 10 \frac{P_t^2}{(N+1)^2 B^2} + 10 \frac{P_t^3}{(N+1)^3 B^3} + 5 \frac{P_t^4}{(N+1)^4 B^4} + \frac{P_t^5}{(N+1)^5 B^5} \right\}
\]

\[
= \frac{P_t}{N+1} \left\{ 1 + \frac{P_t}{B(N+1)} \right\}^5
\]

Given this pattern, we can deduce that at period \( j \), the share of the entrepreneur will
be

\[
sh_j = \frac{P_i}{N+1} \left\{ 1 + \frac{P_i}{(N+1)B} \right\}^{j-1}
\]  

(1)

We assume that the share of the entrepreneur in total profits is entirely re-invested in
the project for buying-out the ownership shares of the financier. If we donate by \( C_{j-1} \) the
entrepreneur's capital contribution in period \( j-1 \) and \( sh_{j-1} \), the entrepreneur's re-invested profit-
share in that same period, the entrepreneur's total capital contribution in period \( C_j \) can be
written as follows:

\[
C_j = C_{j-1} + sh_{j-1}
\]  

(2)

Similarly, \( C_{j-1} = C_{j-2} + sh_{j-2} \)

and so on. Hence, equation(2) can be rewritten to take the following form.

\[
C_n = C_1 + \sum_{j=1}^{n-1} sh_j
\]  

(3)

where \( C_1 = B \). Equation (3) shows that the entrepreneur's capital contribution to the project
in period \( n \) can be expressed in terms of his previous shares.

As the share of the entrepreneur in total profits increases and that of the financier
decreases every year, due to the change in fractional share in ownership, the relationship
between the profit \( P_i \) and the period \( j \) is important. For the project to belong to the
entrepreneur in period $j$, the necessary condition is that his profit-share should be equal to the total profits of the project. In other word, we must have the following equality in period $j$.

$$\frac{P_i}{N+1} \left[ 1 + \frac{P_i}{B(N+1)} \right]^{j-1} = 1$$

which leads to

$$\left[ 1 + \frac{P_i}{B(N+1)} \right]^{j-1} = N + 1$$

$$(j-1) \log \left( 1 + \frac{P_i}{B(N+1)} \right) = \log (N + 1)$$

$$j - 1 = \frac{\log (N + 1)}{\log \left( 1 + \frac{P_i}{B(N+1)} \right)} \quad (4)$$

Equation (4) shows that time needed for the entrepreneur to take over the project under redeemable PLS and under the profit conditions cited above is inversely related to the amount of profit yield. In other words, as $P_i$ increases the time needed for the project to pass under the ownership of the entrepreneur decreases. In addition, computing the derivative of equation (4) with respect to $P_i$, we get:

$$\frac{d (j-1)}{dP_i} = - \frac{\log (N + 1)}{\log \left[ 1 + \frac{P_i}{B(N+1)} \right]} \cdot \frac{1}{P_i + B(N+1)} \quad (5)$$

Equation (5) is negative which shows the inverse relationship between the time period $j$ and the profit $P_i$. As $P_i$ increases, the time period needed for the entrepreneur to take over the project decreases less than proportionately.

Over time, the contribution of the entrepreneur increases, which of course, induces him to increase his effort level and increasing his productivity and consequently increasing the profits. This is so because the entrepreneur is taking more risk by investing by retention more and more from one period to another. This increase in profit as a result of the increase in
productivity through the increase in entrepreneur-ship will have a positive effect in reducing the length of time \( j \) as shown by equations (4) and (5). As \( P_1 \) increases as a result of an increase in productivity, the denominates of the right hand side of equation (4) increases and hence the right hand side of equation (4) decreases, that is \( j \) decreases.

Depending on the motivation for acquisition of ownership, the entrepreneur is expected to improve his effort level, minimize the non-pecuniary expenditures (e.g., on expensive office furniture, attractive secretarial staff, Concord travels etc.), even report the project over efficient, improve his savings and may even seek to mobilize finance from other sources for quickly completing payments and getting ownership. Thus, it can be expected that the incentive for ownership will work as a deterrent against moral problems.

With the passage of time, the financier’s capital contribution to the project diminishes so that the entrepreneur becomes the sole proprietor of the project with respect to the specific financier. As discussed in chapter six, the entrepreneur may have similar redeemable PLS relationship with other financiers too.

As the financier’s ownership of the project decreases, its cash flow improves because, the bank does not only share in profits but also recovers its principal capital in somewhat an amortizing form. With recovery of its initial capital contribution and its own share of profits, the bank can start a new project with another entrepreneur. The financier therefore, becomes a source of generating new projects and a promoter of new entrepreneurs. Subject to conditions of equation (6), the financier’s share in projects can be maintained until the entrepreneurs become self-supporting and be able to enter into competition.

\[
P_j = B (N + 1) \left\{ \frac{I}{(N + 1) - 1} \right\}
\]

Equation (6) shows the relationship between the profit \( P_1 \) and the period \( j \) needed for the entrepreneur to take over the project entirely according to the principle of redeemable PLS and under the conditions cited above.
Different Streams Of Profits

In this case, we assume that the profit yield in each period is different, i.e., $P_1$, $P_2$, ... $P_j$ are different. The entrepreneur’s capital contribution in period $j$ depends on his initial contribution ($B$) to which he adds a part of his profits-share of the previous period. In other words, we assume the following relationship between his total capital contribution in period $j$ and his profit-share in period $j-1$.

$$C_j = B + s_{j-1}$$ \hspace{1cm} (7)

Following this pattern, we can compute the capital contribution and the profit-share of the entrepreneur in each period.

In period 1: $C_1 = B$

$$s_{1} = \frac{P_1}{N+1}$$

In period 2: $C_2 = B + \frac{P_1}{N+1}$

$$s_{2} = \frac{P_2}{N+1} + \frac{P_1 P_2}{B(N+1)^2}$$

In period 3:

$$C_3 = B + \frac{P_2}{N+1} + \frac{P_1 P_2}{B(N+1)^2}$$

$$s_{3} = \frac{P_3}{N+1} + \frac{P_2 P_3}{B(N+1)^2} + \frac{P_1 P_2 P_3}{B^2(N+1)^3}$$ etc.

Following this pattern, we can deduce the following formula for the entrepreneur’s profit-share in period $j$.

$$s_{j} = \frac{P_j}{N+1} + \frac{P_j P_{j-1}}{B(N+1)^2} + \ldots + \frac{\prod_{k=1}^{j} P_k}{(N+1)^j B^j}$$ \hspace{1cm} (8)

Equation (8) can also be rewritten as:

$$s_{j} = \sum_{k=1}^{j} \frac{\prod_{a=k}^{j} P_{j+1-a}}{(N+1)^j B^{k-j}}$$ \hspace{1cm} (9)
where $S$ and $P$ denote, respectively, the sum and product signs.

It is worth noticing that the entrepreneur does not reinvest all his previous capital contribution in the current period. For instance, in period 2, his contribution was $B + \frac{P_1}{N+1}$; and his profit-share was equal to $\frac{P_2}{N+1} + \frac{P_1 P_2}{B(N+1)^2}$; the new capital contribution in period 3 is equal to his profit-share in period 2 plus the amount $B$. Hence, the difference from his second period contribution $\frac{P_1}{N+1}$ will be left to him to use it either for his own consumption, saving or to start another project etc.

As we can notice, it is difficult to get from equation (9) an exact formula that could help us know the length of time needed for the entrepreneur to take over the project. Given this difficulty, we assume that the profits yield in all periods are equal to $P_1^{30}$. From equation (9) the profit share of the entrepreneur in period $j$ becomes equal to:

$$sh_j = \frac{P_1}{N+1} \left\{ 1 + \frac{P_1}{B(N+1)} + \frac{P_1^2}{(N+1)^2 B^2} + \ldots + \frac{P_1^{j-1}}{(N+1)^{j-1} B^{j-1}} \right\}$$

$$sh_j = \frac{P_1}{N+1} \left\{ \frac{1 - \left[ \frac{P_1}{B(N+1)} \right]^j}{1 - \frac{P_1}{B(N+1)}} \right\} \quad (10)$$

Given the initial capital contributions of the financier and of the entrepreneur and the expected profit $P_1$ which is assumed to be the same from period one to period $j$; equation (10) gives us the ability to compute the profit share of the entrepreneur in period $j$. A necessary condition for the entrepreneur to own the project at 100% at the end of period $j$, is that his percentage profit share

$$\frac{sh_j}{P_1}$$

must equal to one. Hence, from equation (10), we get
\[ \frac{shij}{p_t} = \frac{1}{N + 1} \left\{ \frac{1}{1 - \frac{p_t}{b(n + 1)}} \right\} = 1 \]

which implies

\[ \frac{1}{1 - \frac{p_t}{b(n + 1)}} = N + 1 \]

Simple algebraic manipulations lead to

\[ j = \frac{\log \left( \frac{p_t}{b} - N \right)}{\log \frac{p_t}{b(n + 1)}} \]  \hspace{1cm} (11)

Equation (11) gives the length of time needed for the entrepreneur to get over the project. The length of time \( j \) depends on three factors, a) the capital contribution of the financier, b) the capital contribution of the entrepreneur and c) the expected profit in each period assumed to be the same across periods.

8.3 SOME IMPLICATIONS: RECAPITULATED

The present model of redeemable PLS uses the p/s ratio but introduces a number of important changes to the original model.

First, the present model is a firm level contractual model thus much closer to the premises of the MM contracts compared to the original PLS model where monetary implications have eclipsed contractual considerations. Since the present model is also based on a p/s ratio, the monetary implications of the model can be interpreted as in the original model. But two limitations of the p/s ratio must be mentioned as for using it as a monetary mechanism is concerned: a) Given the level of reliance on the mark-up by the Islamic banks, the p/s ratio does not remain as viable a monetary mechanism as it was envisioned in the
original model which perceived the Islamic economy as 100% PLS-based and b) in our model of the PLS, the p/s ratio is more a micro-economic phenomenon as it is individuated compared to the original model. However, we consider that the mark-up mechanism is more suitable instrumental variable as it can be more effectively controlled by the monetary authorities compared to the p/s ratio.

Second, our model introduces an important change in the PLS. As we interpreted the MM as forms of enterprises rather than as modes of financing, the redeemable PLS can serve as a financing mechanism within the framework of an MM enterprise. This conclusion is consistent with the introduction of two types of redeemable instruments by the Modaraba companies in Pakistan. Funds are redeemed by a systematic and gradual withdrawal of the principal amount by the financier. This characteristic of the proposed PLS model takes it closer to the redeeming characteristic of mark-up based funds or even conventional debt finance. Due to its redeemable characteristics, finance will remain neutral to the longer-run ownership structure of the firm. This is most significant change in view of the ownership sensitivities between the financier and owner or between host and foreign parties of a firm.

Third, the present model allows the entrepreneur to retain and re-invest his share in profits to the extent of 100% internal ownership. We are aware that 100% internal ownership is an extreme case. However, this is only representative of a situation of such funds for which the firm is not ready to offer permanent ownership. Indeed, we intend to supplement rather than replace the permanent PLS funds. Our allowance for retention and re-investment of profits by the entrepreneur is expected to introduce efficiency in the firm. As the entrepreneur has the opportunity to re-invest in the firm, his decision to invest outside will signal the superiority of the outside investment opportunities. Thus, the entrepreneur is forced to invest in the firm managed by him. As his stake in the firm increases, he will have the incentive to work harder.

Fourth, the financiers’ promotive role is enhanced in our model. In the original PLS model, once a contract is signed, the financier takes permanent stake in the firm unless it finds another buyer. In the present case, the financier systematically gets out from maturing projects and takes up stakes in infant projects. Thus the financier shares the risks of infant
and gives up ownership stakes of projects which mature and become familiar with risk and acquire assets by re-investing their profits. Such a promotive role by the financial institutions is highly needed in the developing countries.

Finally, the proposed arrangement combines the prime merits of mark-up and PLS. The merit of the mark-up is that it facilitates the acquisition of assets. The prime merit of the PLS is that it links financiers’ interests with the outcome of projects, thus introduces efficiency. The proposed redeemable PLS facilitates acquisition of assets i.e., renders the functions of mark-up, but through the PLS mechanism.

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1Khan (1985).
3Lessard and Williamson (1985) p 64.
4This subsection is adopted from Boulem and Khan (1995).