Chapter 6

PROFIT SHARING IN RETROSPECT: FIRM LEVEL CONSIDERATIONS

6.1 INTRODUCTION

In chapter four we analyzed some alternative explanations for the non-existence of PLS in the Islamic bank’s operations. In chapter five we took up the case of the market performance of the pure PLS and found that the market for the PLS does not at all reward risk. Among many reasons we explained that the PLS companies in our sample relied only on a solitary financial instrument, namely, *muḍarabah certificates* compared to the several instruments available in the conventional markets. As a result the PLS was not able to perform well in the market in terms of acquisition of value for investors and rewarding risk.

In the present and the following chapters we look at the PLS in retrospect. In the present chapter we critically look at the PLS from the micro (firm level) perspective. We saw that the PLS is dominated by the mark-up as far as the operations of Islamic banks are concerned. It did not perform well in the financial markets where it was applied in its pure form. Nevertheless, participation in the capital of enterprises offers a crucial investment opportunity for investors who abstain from interest; the enterprises, in turn, mobilize resources. Ideally, capital participation entails providing finance in the form of funds¹ by acquiring ownership. Examples of participation in the risk of an enterprise are the ownership of capital shares in *mushārakah*; the ownership of capital and entrepreneurial qualities in *muḍarabah* and the resultant responsibilities for the uncertainty of outcome respectively, in the two cases.

Due to the striking contrast of the PLS principle with interest, the articles of agreements establishing some Islamic banks have given priority to the use of PLS in their operations². However, in their present practices, the participation of Islamic banks in the capital of enterprises is negligible. Islamic scholars have been urging³ the Islamic banks to enhance the flow of participatory capital in their supply of funds. However, the Fiqh Academy of the Organization of Islamic Conference, in a number of meetings, has asked the Islamic
banks to refrain from participating in the capital of such companies which have interest-based assets/liabilities in their balance sheets⁴.

The above considerations imply that the Islamic banks should enhance their capital participation in enterprises, but, should at the same time, avoid investing in leveraged firms. Apparently, the conclusion is paradoxical: Does it mean that for all practical purposes, the Fiqh Academy ruling prohibits the Islamic investors from investing in existing enterprises?

Prohibition of capital participation in enterprises has important economic implications. Many investors must withdraw their existing funds from leveraged enterprises. Consequently, the basket of investment opportunities will reduce having adverse implications for savings and growth. Thus, efforts must be made at academic as well as policy levels to enhance capital participation in enterprises within the framework of the premises provided by the sharia’h ruling. The ongoing efforts in this regard can broadly be classified into two groups.

The first group of efforts is related to the exploration of possibilities where existing interest-based debts of specific firms could be replaced by Islamically acceptable alternatives⁵. Once the capital structure is cleaned from interest, investors can participate in the capital of such enterprises. The crucial parameters for the success of these efforts are: i) Willingness of the management of enterprises to replace their existing interest-based debts with Islamically acceptable forms of funds, ii) Availability of the Islamic alternatives to achieve the objective and iii) Once the capital is replaced appropriately, its maintenance overtime.

If a typical firm is willing to replace its existing interest-based debts, what are the possible Islamic alternatives?⁶ The problem is simply one of availability of cash, so that the firm can pay its debts. In this regard, the ongoing efforts refer to some possible arrangements. The cash-fund may be provided by an Islamic financier by purchasing part of the assets of the indebted enterprise and either selling these back on installments, leasing them back⁷ or assuming the role of a partner in the enterprise. In addition, flow of the company’s retained savings may be diverted towards the payment of the debts. This can be ensured if an Islamic financier provides funds to meet those needs which the company would have otherwise met.
by its retained profits. The cash flow of the enterprise may be enhanced by raising its equity capital.

The above mentioned efforts of cleansing the capital structure of companies from interest, are nevertheless, limited in nature as these depend on the willingness of the companies (management commitment cannot be ensured for ever). While these efforts are underway, some basic questions must also be addressed to: Why, in the first instance, interest enters in the capital structure of enterprises? How to avoid the entrance of interest in the capital of enterprises in their infancy? How to let the enterprises grow without using interest? For, if there is any analogy between raising up a human being and an enterprise, the enterprise like the human being must be put into the right direction from its infancy. Thus, a rather fundamental consideration is the development of comprehensive participatory Islamic financial instruments which can meet the requirements of enterprises at their infancy and through out their growth.

The central point of the present chapter rests on the proposition that because of its redeeming feature, debt (whether it is the result of mark-up or interest-based credits) is preferred particularly, by sole proprietorship enterprises. Due to this preference, debt enters the capital structure of sole proprietorship enterprises at their infancy. As the enterprises grow, they contract one debt after another. Hence, although each debt contract redeems, certain level of debt permanently remains in the capital structure of enterprises. This implies that enterprises which prefer debt for its redeeming nature, should equally prefer redeemable profit and loss sharing arrangements of financing.

Given the above background, the present chapter aims at putting forward some considerations for enhancing capital participation in enterprises within the framework of the OIC Fiqh Academy Resolution. The specific objectives of the chapter are to discuss the:

1. Limitations imposed on the wider use of profit sharing principle of Islamic financing by the non-redeemable nature of the notion of PLS prevalent in the existing Islamic banking literature,
2. Need for, and feasibility of redeemable PLS for use in ongoing enterprises, such as sole-proprietorships,

3. Implications of redeemability of PLS for profit retention, self-financing and growth of interest-free enterprises and

4. Possibility of subordinating the sale-based financing to the PLS and its usefulness in enhancing the cash flow of Islamizing enterprises.

Section Two of the chapter briefly discusses differences between modes of financing, forms of enterprises and a comprehensive financing mechanism. Section Three, argues that an enterprise has the right to prefer any type of Islamically defined ownership structure. Maintaining this ownership structure, it must also be given the right by the society for a comprehensive profit and loss sharing financing instrument. In Section Four, it is argued that a redeemable financial instrument has the capability of providing a comprehensive profit and loss sharing financing mechanism, which can simultaneously be neutral to the longer-run ownership structure of the enterprise. Section Five, tries to invoke support for the scheme of re-payment of *mudarabah* funds discussed in section four. Section Six argues that a redeemable financial instrument is also expected to promote self-financing, thus ensure growth as well as restrict the enterprises exposure to interest to a minimum level. Section Seven puts forward some considerations to subordinate sale based finance to the PLS and enhance cash flow of Islamizing enterprises.

6.2 COMPREHENSIVE FINANCING MECHANISM AND ITS NEED IN AN ISLAMIC ECONOMY

In the present section, it is argued that in order to effectively replace interest, the Islamic economy needs a comprehensive financing mechanism. In the absence of such a mechanism, even if the capital structure of an enterprise is cleansed from interest, overtime, the maintenance of such an interest-free capital structure may not be possible. On the other hand, if a comprehensive Islamic financing mechanism can be devised, not only interest can be
prevented from entering in the capital of enterprises but also existing enterprises may be able to replace their interest-based debts at a larger scale.

6.2.1 Modes of Financing and Comprehensive Financing Mechanism

In the outset, a comprehensive financing mechanism may be defined as a financing facility which provides monetary financial accommodation to enterprises but remains neutral with respect to their longer-run ownership structure. In order to understand the relevance of such a mechanism for the Islamic economy, there is a need to thinly define and differentiate between a mode of finance and a comprehensive financing mechanism.

Profit sharing and deferred sale are the two parent principles of Islamic financing. Installment sale (in fact, installment purchase, which uses the mark-up mechanism) and leasing (in fact hiring, which uses the renting mechanism) and mudarabah, etc., are examples of modes of finance derived from the parent principles. In addition, one may also finance, for instance, the construction of a house on one plot from funds generated by the sale of another plot (if one possesses an additional one!). Similarly, one may finance one part of one's enterprise, by accepting new partners after selling its part as stocks. Selling a plot or part of a company, is simple sale (mostly spot, as such sellers in general, need lump sum), yet, both sales function as modes of finance.

Although, hiring, installment purchase, and spot sale of owned assets and mudarabah etc., serve the purpose of financing but, neither of these can function as a comprehensive financing mechanism. Exhibit 6(a), highlights this comparison between the implications of a mode of finance and a comprehensive financing mechanism for an enterprise. Hiring and installment purchase are not comprehensive, because, these are specific to the equipment/assets in question. For some reasons, if the company needs cash, installment purchase or hiring does not directly meet such requirements. But on the other hand, if cash is available to the enterprise, it can always purchase the required equipment. Mudarabah and musharakah arrangements directly meet the company's cash requirements. But both of these essentially lead to a change in the ownership structure of the enterprise. Thus, enterprises which need cash, but, for the time-being, not wanting or being able to change their ownership structure would find hard to compromise.
The summary of Exhibit 6(a), is re-produced as Exhibit 6(b). The choice of most enterprises for a financing mechanism is expected to be effected by three basic inter-related considerations: i) acquisition of, or access to equipment by the enterprise, ii) direct adjustment of the enterprise's cash flows\(^{10}\) and iii) separation of the financing decisions from decisions related to the ownership structure or non-interference of the financing mechanism in the ownership structure of the enterprise.
### Exhibit 6(a) Comprehensive Financing Mechanism and Modes of Financing

<table>
<thead>
<tr>
<th>Financing Mechanism</th>
<th>Form of Financing received by the enterprise</th>
<th>Effect of Financing on the Enterprise</th>
<th>Implications of the Financing Mechanism for the Ownership Structure of the Enterprise</th>
<th>Possible Response of the Enterprise to Ownership Implications of the Financing Mechanism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale-based Modes</td>
<td>in kind</td>
<td>Addition to or replacement of equipment</td>
<td>Expansion in the asset-base thus liabilities but no change in the ownership structure. Enterprise strengthened by the addition of new assets</td>
<td>If there is a need for the equipment, it will be a welcome addition</td>
</tr>
<tr>
<td>Leasing</td>
<td>in kind</td>
<td>Addition to or replacement of equipment</td>
<td>No change in asset-base thus liabilities. No change in ownership structure. But, since the equipment is only temporarily attached to the enterprise, in the longer-run its implications could be adverse.</td>
<td>If the purchase of the equipment is not feasible, the enterprise will unwillingly rely on the borrowed equipment</td>
</tr>
</tbody>
</table>
| *Musharakah* or *Mudarabah* | in kind or cash | a) Addition to or replacement of equipment  
b) Direct adjustment of cash flow | If the enterprise is a one transaction activity, the expected ownership change is irrelevant. But if the enterprise is an ongoing activity, the ownership structure of the enterprise must change. Addition to asset-base but no change in liabilities as such* | An excellent option for a one transaction enterprise. But for an ongoing enterprise, where ownership change is inevitable, the decision will depend on the needs of the enterprise and its preference for the change. |
| Comprehenssive Financing Mechanism | cash | a) Addition to or replacement of equipment  
b) Direct adjustment of cash flow | No change in the ownership structure, but addition to the asset-base, no change in liabilities as such* | Best preference if the enterprise is not willing to undergo any type of ownership change, particularly if cash is needed. |

* It may be noted that, in the balance sheet of an enterprise each asset must have a corresponding liability, in this sense the liabilities must also change as a result of the change in the asset-base. Nevertheless, these financing mechanisms do not create any fixed liabilities. The relevant connotation is used in this sense.
From the brief comparison of Exhibit 6(b), it can be seen that installment purchase and hiring, simultaneously meet only two namely, acquisition or access to assets and non-interference in the ownership structure, out of the three requirements of the firm. These two modes however, do not meet the requirement of the enterprise for direct cash flow adjustment. The *muḍārabah* and *mushārakah* mechanism, on the other hand meets both the requirements for asset acquisition and direct cash flow adjustment, but aggravates the non-interference requirement. A comprehensive financing mechanism is one which meets all the three requirements simultaneously. An interest-free comprehensive financing mechanism is thus needed by an Islamic economy.

**Exhibit 6(b) Matching Financing Mechanisms with Important Considerations of Enterprises**

<table>
<thead>
<tr>
<th>Financing Mechanism</th>
<th>Acquisition of or Access to equipments</th>
<th>Direct adjustment of cash flows</th>
<th>Non interference of financing in the ownership structure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Installment purchase/hiring</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
</tr>
<tr>
<td><em>Muḍārabah</em> <em>Mushārakah</em></td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Comprehensive financing</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

From what is discussed above briefly, the following characteristics of a an Islamic comprehensive financing mechanism can be derived: i) It is a mechanism which by itself is derived from a financing or enterprising principle, ii) It is always available in the form of cash, iii) It does not interfere in the organizational structure of the enterprise, iv) It remains in the ownership of the provider, v) It is in general capable to replace all other forms of finance in an ongoing enterprise and vi) In the longer-run perspective, it does not cause a change in the ownership structure of the enterprise.

**6.2.2 Forms of Enterprises and a Comprehensive Financing Mechanism**

Most Islamic modes of financing have the dual connotation of mode of financing and form of enterprising. In fact, in their original form, the characteristics of *muḍārabah, mushārakah, muzara', musaqa' and istīsna'[ in the sense of enterprises or companies are more dominant than their characteristics as modes of financing. Indeed, a *muḍārabah* or *mushārakah* enterprise is established to overcome the difficulties related to both manpower
and finance. As a comprehensive financing mechanism must be in the form of cash, among the Islamic forms of enterprises, only the first four arrangements remain relevant for comparison. The limitations of these business forms in rendering financing functions at a wider scale can be identified with their requirement to establish new enterprises, each time, when more funds are needed.

In most forms of the above mentioned enterprises the required manpower (management) as well as assets (financing) are equally important. In fact, the enterprise is the result of an integration and combination of human and financial resources. Thus, after the integration of funds and human resources, one cycle of the function of finance, namely establishing the enterprise is completed, but, another crucial cycle of the need for finance emerges. The difference between these two cycles is crucial: In the first instance, establishment of the enterprise (in the present case, the ongoing enterprise) is eminent, where in the second case it is not.

This is the case with all modern forms of enterprises too. First, whether, sole proprietorship, partnership, or a joint stock company, all enterprises, need funds and human resources for their establishment. Second, with their establishment, the need for financing does not however, discontinue. For instance, its own profits, and bank borrowings may be a main source of financing the sole proprietorship, the partnership company may in addition sell its own debt instruments, and the joint stock company, will in addition sell its parts as common stock, or resort to quasi-debt such as preferred stocks. In any case, we cannot think of one form of an enterprise, e.g., partnership to serve as a mode of financing for another form, e.g., a sole proprietorship and vice-versa.

In context of the modern enterprise as an ongoing concern, the same logic is applicable to the Islamic forms of business organizations. For instance, when a musharakah or mudarabah company is established, the matter of its financing continues. In the most common form of the traditional mudarabah - a single transaction enterprise, the differentiation between the two cycles of financing is not required. But, if a mudarabah or musharakah enterprise of longer-term duration is visualized as an ongoing concern, e.g., in the form of partnership, joint stock companies, the Unit Investment Fund of IDB or Pakistani
Muḍarabah Companies, etc., the difference between the two cycles becomes evident. Overtime, the muḍarabah or mushārakah company will itself need financing. Moreover, as a sole proprietorship and a muḍarabah are two different forms of enterprises, we should not expect any one of these enterprises to serve as a financing mechanism for the other enterprise.

The last is an important point and needs further elaboration. For illustrative purposes, a muḍarabah enterprise or a sole proprietorship as an ongoing concern can be considered. Suppose, after one year of operation, the enterprise needs more funds for expansion. Can the muḍarabah or mushārakah be used to raise the additional funds? The answer is yes, provided either or both of the following two restrictive conditions are met.

First, an enterprise requiring more funds could identify an independent transaction within the enterprise, which can be financed (can constitute a subordinate enterprise) by a new muḍarabah. For example, if the enterprise is a grocery store, it can identify edible oil to be financed by the new muḍarabah - a subordinate muḍarabah enterprise will be established. The operational results of trading in this item will be calculated to meet the muḍarabah conditions. In some businesses such an arrangement is possible. But the practical difficulty with a larger scale use of this method is that the profitability of an enterprise, in general, can be calculated only after aggregating the profits and losses of the operations of different sections of the enterprise. Many items in the grocery store for example, may not actually be generating substantial profits but these items may be essential to attract clients for the store. Moreover, consider advertising costs; on what items the store should charge these? Therefore, for practical reasons it is extremely inconvenient to identify specific items, each time when new funds are needed. We believe that this is one of the difficulties due to which the much cherished profit sharing principle is not widely used by the Islamic banks.

Second, if funds are needed for expansion and business sections cannot be identified for new mudharabas or musharakas the enterprise has to admit new mudharibs/mushariks (partners) e.g., by issuing profit sharing financial instruments. Besides the cost of such arrangements, this option is suitable only for those enterprises which are willing to change their ownership structure. As discussed in the subsequent sections of this
chapter, in the Islamic economy we shall expect to have numerous enterprises needing funds but for many reasons not willing to change their longer-run ownership structure. How to meet the financing needs of such enterprises? The limitation for *mudārabah* and *mushārakah* to meet the need of these enterprises shall persist, as these are basically business forms. Again, we believe that the practical non-existence of profit sharing in Islamic banking is also related to this difficulty.

6.3 THE ROLE OF A COMPREHENSIVE FINANCING MECHANISM IN THE CAPITAL STRUCTURE OF ENTERPRISES

In the previous section a comprehensive financing mechanism was defined as an arrangement which meets the cash requirements of enterprises but remains neutral to their longer-run ownership structure. The conceptual difference between this and a mode of financing and the limitations of using a form of enterprise as a financing mechanism were also discussed. In the present section, the preference of different enterprises for such a comprehensive financing mechanism is briefly discussed in the context of strengthening the finance-enterprise relationship in the capital and entrepreneur scarce Muslim countries.

6.3.1 Initiating Infant Enterprises

In the Muslim countries, in general, the entrepreneurial class is nascent. As technological progress and growth of all economies depend on entrepreneurial risk-taking, recent research on Islamic economics has rightly raised the issue of promotion of such qualities through small enterprises\(^\text{13}\). Sole proprietorships require the entrepreneur to borne all risks of the enterprise. The bankruptcy risks confronted by infant entrepreneurs, in fact, may not allow entrepreneurs to initiate enterprises\(^\text{14}\). Since capital participation by a financier will spread the risks of the enterprise, it can thus encourage the entrepreneurial functions.

We argued in chapter four that when the enterprise starts functioning, the entrepreneur gets acquaintance with its operation, his risk profile improves, and he is expected to manage more and more risks over time. The proper development of this improving risk profile is in the interest of the financial and economic system. In this regard, the
most effective mechanism would be to assign more and more ownership responsibilities of the enterprise to the entrepreneur. The logical implication of this mechanism is a gradual withdrawal of the financier from the project by redeeming his funds. This will also relieve the financier to support other infant projects. This reasoning, nevertheless, implies a reverse-order capital structure relationship. As a convention, when an enterprise grows it sells stocks. In the present case, as the enterprise grows, it is expected to become a sole proprietorship. Nevertheless, in context of Muslim countries, for instance, Bangladesh, Indonesia or Pakistan, such a promotional policy can be considered logical and rational.

6.3.2 Capital Structure of Sole Proprietorships

As single person owned enterprises, normally, sole proprietorships are established either by borrowed resources or out of the savings of the owner. In either case, the entire liabilities of the enterprise, rest on the owner-operator. Some of these enterprises actually die in their infancy, some close after attaining maturity while many others develop into corporations of different sizes. The significance of such enterprises can be seen from several facts related to them. For instance, these enterprises are effective source of productive engagement of manpower, particularly, in the capital-scare developing countries. Being owner-operated, these may even be efficient. Major innovations are undertaken by them.15

The existence of sole proprietorships at a large scale, in itself is an evidence of the fact that for certain justifications of their own, the owners of these enterprises prefer their typical ownership structure. As sole proprietorships do not like to associate others with their enterprise, they cannot utilize musharakah or mudarabah finance. Even if these opt to mobilize funds by issuing stocks to the public, they cannot do so until their operations reach a certain minimum size. In addition, the relative cost of issuing stocks is much higher for smaller enterprises compared to bigger firms, effecting their relative competitiveness.16 The availability of appropriate form of finance (finance which is consistent with their ownership structure) is an important known factor for the growth of these small enterprises into joint stock companies.
The capital structure of these enterprises may contain debt as a natural result of shortage of internal resources to finance either the establishment of the enterprise or its expansion. But, since these are solely owned by a single person, by definition, the capital structure of such firms shall never contain external funds such as *mudārabah*, *mushārakah*, or common stock. In other words, due to their typical ownership structure, these enterprises could not benefit from the traditional Islamic participatory modes of financing or from equity finance. This should be seen as a universal rather than a localized phenomenon\(^\text{17}\). Hence, in the absence of an Islamically acceptable comprehensive financing mechanism, these enterprises could face serious financial constraints compared to enterprises which can use interest-based finance. Since comprehensive Islamic finance in not available in the Muslim world, enterprises which use interest-based funds are in a relatively advantageous position compared to those which avoid interest. Once grown as corporations on the basis of interest, it is natural for these corporations to become indifferent to the Islamic injunctions against interest as e.g., re-activated by the *Fiqh* Academy resolution mentioned above.

It may not be just to ask the enterprises to sacrifice their ownership characteristics if they need financial accommodation. Nor, such an administrative arrangement sounds efficient or even logical economy-wise. The right approach, in our opinion, is therefore, to evolve a scheme of permissible financial accommodation which could also be consistent with the universal preference of these enterprises for the form of capital structure. The problem is one of meeting the cash needs of a sole proprietorship for establishment and growth, but at the same time, without changing the structure of the enterprise. Thus conceptual efforts as well as institutional arrangements are required to provide such a financing mechanism in conformity with the ban on interest.

In the developing countries, sole proprietorships mostly get finance from informal sources. In the traditional Islamic framework, financial accommodation in the form of cash can only be provided either as *qarḍ* (interest-free loan) or by participating in the risk profile of the enterprise through *mudārabah* or *mushārakah*\(^\text{18}\).

Individual motivation, for example, for the construction of a house, for the purchase of a consumer durable, for the education of a child etc., is a primary factor in effecting the
saving choice. Inflation wipes away a large part of the purchasing power of these savings. Individual savers whose choice pattern is not effected by the prohibition of interest, to some extent, can however, neutralize the eroding effect of inflation by interest-based investments. But, individual savers who are conscious about the prohibition of interest, are hence, left with a dilemma; to forego present consumption, save, but only to be wiped away by inflation! It is obvious that two individuals, otherwise facing similar conditions, but one being disappointed with investment opportunities or even not being able to protect the purchasing power of his savings will save lesser compared to the one who enjoys at least some investment opportunities.

Islamic banking facilities are not available to an overwhelming number of the population which is conscious about the prohibition of interest. Informal participation in the capital of enterprises can however, provide investment opportunities to a significant segment of the Muslim individual savers. There may be numerous sole proprietorships needing such funds. The two can benefit from each others complimentarities, but, only if, the funds are consistent with the legitimate preferences of the enterprises. Again, a mechanism to informally bring these two parties together is in the larger interest of the society.

6.3.3 Capital Structure of Joint-Stock Companies

The discussion of this sub-section inevitably leads us to the controversy between different theories of capital structure of the firm. The competing theories try to explain several related phenomenon: Why some firms rely more on internal financing compared to others? Why firms combine debt and equity? Why firms issue common and preferred stocks? Why firms sometimes buy their own stock? What is the optimal policy related to these issues? Why this optimal policy is different for different firms and even for the same firm in different times? These numerous and complex issues are thoroughly analyzed in the relevant literature. It is not the objective of this chapter to deal with these complex issues. In this context, in a broader sense, it is relevant to mention that, after decades of domination by the neo-classical and Keynesian theories (led by the Miller-Modigliani propositions), the traditional capital structure theory has re-emerged. In simple terms, the intuitively appealing implication of this several decades old theory is that, the first preference
of firms is to finance their growth from internal sources. If firms have to choose between debt and equity, they will prefer debt simply because it is consistent with their first preference. The preference for internal financing, is in fact, a preference for internal ownership. The stronger is the internal ownership, the more it is secure to borrow, i.e., borrowing is consistent with internal financing. On the other hand, the strength of internal ownership in fact, weakens external ownership and vice-versa

The re-emphasis on this theoretical premises has been strengthened by at least two considerations. First, tax, bankruptcy, and agency costs (moral hazard, adverse selection etc.), all relate to external (stocks) rather than internal financing. Second, profit retention (which is a positive function of the size of internal ownership and an inverse function of external ownership) improves cash flows and capital base of the firm, hence enhances its growth prospects. In chapter four we reported the results of some recent studies revealing that for the 1970-85 period, in average, corporations in the G - 7 countries met 73% of their financing needs by their retained earnings, 22% through longer-term bank-industry relationships as direct equity linkages or loans and the remaining 3% through stock markets. The average figures for direct bank-industry relationships are in fact inflated by the high dependence of West German and the Japanese Corporations on this source of funds.

This evidence suggests that even in the economies where they are expected to function most efficiently, the stock markets are not effectively promoting savings which is considered to be their important function. As major companies are financing their growth through retained earnings (not issuing much new stocks), the volume of daily turnover in the stock markets, is an act of speculation, rather than real investment. The day to day hazards of speculative practices in the stock markets and the resultant damage to the wealth of the society is equally criticized by the Islamic scholars as well a large number of Western economists.

Referring to similar problems, one of the most prominent contemporary analysts of capitalist institutions raises a serious objection on the stocks as "investments that are not associated with particular assets". As such, the risk of expropriation is quite substantial. The risk is due to the fact that "the assets in question are numerous and ill-defined and cannot be
protected in a well-focused, transaction specific way” (emphasis added)\(^{23}\). As Islam puts emphasis on well defined property rights, this observation need to be taken seriously by Islamic economists.

Stock markets have also contributed to the elimination of risk-aversion by enhancing portfolios of assets whose returns are negatively correlated. As a result, under the normal functioning of the market, even with a decline in the price of a stock, for instance, from $30 to $10 next morning, investors still stand gainers because the price of the other assets held in the portfolio must increase. Thus the gambling process and the short-termism is permanently vitalized. In the existence of such a trend non would be willing to accept a lower (competitive) rate of return. The cost of capital eventually aggravates the efficiency of the production system - a popular explanation for the competitiveness of Japanese bank dominated economy over the relatively stock market oriented US and European economies\(^{24}\).

Given the fact that corporations in the developed market economies have met only a small part of their total financing needs, the existence of trading in billions of dollars every day is the result of mere speculation. A little more reliance of these companies on such a method of financing could further increase the speculative process and further undermine the competitive basis of the market system. So, the minimum existence of common-stock financing in companies capital structure must be considered as a prudent policy on their part.

In the chapter four we made an attempt to explain the reasons of the overwhelming use of mark-up (Islamically approved form of debt financing) by the Islamic banks within the framework of the traditional theory. An implication of this approach is that the overwhelming existence of mark-up is also related to the preferences of the companies as user of funds. This consideration opens the possibility of exploring such strategies for capital participation in enterprises which like mark-up can be consistent with the preferences of the enterprises.

Again, therefore, in the absence of a comprehensive financing mechanism, which can at the same time be consistent with the considerations of firms for ownership, their reliance on the mark-up can be considered as a sound second best option. If mark-up is reduced, capital requirements will be met by increasing reliance on stocks/PLS. Given the present experience
with stocks, a greater reliance on the mechanism of financing is not prudential. Evolution of a comprehensive PLS financing mechanism can thus meet these considerations of the enterprises. It may be suggested that financing through the mark-up or debt in general, strengthens internal ownership, because it is redeeming in nature. The debt may be a long-term one, but each time contracted, it has to be re-paid and it is not going to stay in the capital structure of the enterprises permanently. If debt financing is preferred by the enterprises for its redeeming nature, for the same reason, participatory financing will also be preferred, provided that it is also redeeming in nature.

6.4 DECLINING PROFIT AND LOSS SHARING: A COMPREHENSIVE ISLAMIC FINANCING MECHANISM

In the preceding sections, it was argued that within the framework of Islamic interest-free economy, the right of enterprises for a comprehensive financing mechanism need to be recognized. A comprehensive financing mechanism was defined to be a device of providing funds through participation in the risk of an enterprise but without interfering in the enterprise's longer-term ownership structure. Further, it was argued that because of its redeeming nature, therefore non-interference in the ownership structure, debt is popular among enterprises. Since, Islam prohibits the provision of funds on the basis of fixed return, a comprehensive Islamic financing mechanism can only be based on the parent principle of participation in the risk profile of an enterprise. In the present and following sections, broader outlines of the proposed redeeming PLS mechanism are proposed and some related issues are analyzed.

6.4.1 Issues in the Redeemability of PLS Funds

Are the funds provided under *mudarabah* and *mushārakah* redeemable? Some researchers consider that in their pure forms, these two Islamic modes of financing are redeeming in nature. As redeemability is closely related to the manner in which the principal funds are re-paid, a closer look at the re-payment method of the principal of *mudarabah* and *mushārakah* funds is therefore, required. However, before discussing whether these funds are redeemable or not, it is important to describe the specific notion of redeemability of funds as adapted in the chapter.
The re-payment of the principal funds depends on the nature of the specific activity which uses the funds in question. Some activities seeking finance are simple and single operation transactions. In such cases, the issue of redeemability is irrelevant as all funds will retire together with the conclusion of the transaction. Whereas, an overwhelming number of contemporary activities seeking finance are in fact inseparable parts of ongoing enterprises. One part of the funds (the permanent equity) of such enterprises cannot be retired. But often, a greater proportion of funds is retired on the basis of contractual agreements about timely planned re-payment schedules.

In the present chapter, all retiring funds as treated redeemable. These funds are usually of two types. A smaller, yet, an important part of the funds is re-payable in lump-sum at maturity. In the conventional economy, short term debts are examples of such funds. A significant part of all retiring funds is however, amortized in installments. Contractually, these installments mature at different time intervals. This maturity structure is of vital importance as it enables the enterprises to manage their cash flows conveniently. Long-term debts particularly created as a result of fund flows are examples of such funds.

With regard to re-payment of the principal of mudarabah funds, a distinction must be made between the pure (traditional) form of mudarabah, and the mudarabah principle used by the Islamic banks on their deposits' side.

Non Redeemability of the Pure mudarabah Funds

In the traditional sense, the principal of the mudarabah can be re-paid only after the calculation of its growth. In general, both the mudarabah and musharakah enterprises are started with monetary contributions. Hence, calculation of capital growth is possible only when all non-monetary assets of the enterprise are transformed into money. The amount of monetary increase in the principal funds deployed constitutes profits and a decrease in them losses. This type of calculation of capital growth is a factual rather than hypothetical phenomenon. It is important to note that in case of pure mudarabah, this factual calculation of capital growth is a result of conclusion and liquidation of the enterprise. It is therefore, a rule not exception.
Two types of mudharabas are known: transaction specific and time specific. Whether the funds are provided for carrying out a specifically identified transaction or provided for non-specific transaction but for utilization within a specific time frame, with the conclusion of each mudarabah the contracting parties depart. It is only due to this reason, i.e., factual liquidation of each enterprise, factual calculation of capital growth becomes feasible. As the enterprise liquidates, all funds are retired, together. Thus, the funds of pure mudarabah and musharakh, in fact, resemble the permanent equity of a modern enterprise; hence, non-redeemable.

But if the enterprise is non-liquidating i.e., if it is an ongoing concern, factual calculation of capital growth is not feasible. Since, ongoing enterprises are the product of the industrial age, the re-payment of the principal amount of musharakah and mudarabah in such enterprises is therefore, an entirely contemporary phenomenon. This phenomenon has two important aspects.

First, most ongoing enterprises periodically prepare balance sheets reflecting their respective depreciation, assets-liabilities and profit-loss positions. Instead of actually liquidating an enterprise for the calculation of capital growth, these estimated evaluation (tandhid al hukmi) reports can be treated as the basis for the calculation of capital growth and payment of the mudarabah profits.

However, re-payment of the principal amount of mudarabah funds being utilized in non-specific activities of an ongoing enterprise is one of the most important complications confronted in the application of the mudarabah principle. Would that the principal was also re-paid, the retiring funds could have been characterized as redeeming. Although profits can be paid on the basis of periodic evaluation reports, a great difficulty is encountered in the re-payment of the principal funds of mudarabah until factual liquidation of the enterprise is undertaken.

Second, if funds are made transaction specific, after evaluation reports, whatever, capital growth is obtained, the funds will be re-paid in lump-sum. In other words, the vital importance of gradual retirement of the funds by gradual re-payment needs further conceptual
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Investigation. In our understanding, the gradual rather than abrupt re-payment of the mudarabah funds and profits is of immense importance. We do not need to go into the detail of this obvious point. However, it may be reiterated that gradual re-payment of the funds enables the enterprise to manage its cash flows with ease and efficiency\(^{27}\), among several other benefits.

**Redeemability of Bank Deposits as Mudarabah Funds**

The deposits’ side of the Islamic banks presents an important contemporary example of wide scale utilization of the profit sharing principle underlying mudarabah. In many respects, this application has widened the horizon of the traditional concept\(^{28}\). The Islamic banks use the mudarabah principle as a resource mobilization technique. The bank as a legal entity is one person (mudharib-manager of funds), dealing with numerous suppliers of funds (depositors-owner of funds). It is noteworthy that unlike in the original form of mudarabah, in case of the deposits of Islamic banks, in general, PLS deposits are not rigidly linked with the operation of any specific transactions and depositors withdraw the principal amount of their deposits at wish.\(^{29}\). A depositor must wait for the forthcoming evaluation for sharing profits, but can withdraw by foregoing his profit claims for the unevaluated period.

We noted earlier that the pure mudarabah is in fact a form of business enterprise. In case one party ceases to continue, the enterprise shall also come to an end. In case of the PLS deposits of Islamic banks, normal withdrawals do not affect the operations of the bank as a mudarabah enterprise. In this manner, the deposit side of the Islamic banks is a major departure from the original form of the enterprise, while at the same time using the basic principle of profit and loss sharing.

Conceptually, the depositor-bank relationship is the same as the rab al mal and mudharib relationship. Keeping in view the condition of an evaluation period for profit claims, PLS depositors, in general, are free to deposit their money at will and to withdraw at will, often, in proportions and amounts of their choice\(^{30}\). If we consider the depositors as financiers, their funds can be considered as redeemable capital, as the withdrawal of these in normal circumstances will not create any hazard for the banks as ongoing enterprises. This
is so because each PLS deposit is considered as an enterprise in itself. In this way, the
Islamic bank is involved in as many enterprises as its *mudārabah* depositors. The cost of a
premature liquidation of this typical enterprise for the depositor (*rab al maʿl*) is negligible
because, factually an individual deposit is not specifically linked to any real economic activity;
although as a pool, these constitute the bank as an enterprise. The cost of the premature
liquidation of a deposit-enterprise for the bank (*mudharib*) is also negligible for the same
reasons and for the fact that the depositors are numerous.

Thus, we observe that there is a disguised but an important dichotomy between the
contemporary practice of *mudārabah* on the deposit side of Islamic banks on one hand and
an expected *mudārabah* on the assets' side of these banks (for the same reasons between
individual *rab al maʿl* and *mudharib* related in ongoing enterprises) on the other. In the
previous case, the Islamic banks have benefited from the book keeping and balance
experience of modern ongoing enterprises including conventional banks. This has not been
done in the second case as *mudārabah* on the asset side of the banks is still subject to the
conditions of the traditional *mudārabah*. The traditional *mudārabah*, though not restricted to
but were predominantly practiced to finance single transaction trading activities. Thus, it can
be concluded that, through *tandhid hukmi* (annual evaluation) and linking *mudārabah*
deposits (funds) with the general performance of the enterprise (bank) rather than a specific
activity in it, the basic principle of profit sharing has been adapted to suite the liability side of
Islamic banks. In principle, it should also be adapted to meet the requirements of financial as
well as non-financial ongoing enterprises on their asset as well as liability side.

**Implications of Redeemability of Finance for Ownership Structure**

As emphasized in the opening paragraph of this chapter, the essence of PLS financing
lies in taking the responsibility of the risk inherent in ownership of assets. In pure *mudārabah*
the financier wholly owns the capital of the enterprise and wholly bears the risk of loss of this
capital. In pure *mushārakah* each party bears the loss of his part of ownership. We
concluded that pure *mudārabah* and *mushārakah* contracts impose ownership
considerations on the firm's financial policy. In other words, the firm cannot acquire funds
unless it is willing to change its ownership structure. A large number of enterprises, obviously,
cannot compromise with this condition. As a compromise solution, we proposed that in order to be universally acceptable, the PLS arrangement should be flexible with respect to the longer-run ownership structure of the enterprise. An objection can thus be raised: How can the PLS principle remain neutral with respect to the ownership structure of an enterprise?

An infinite life span of an enterprise and infinite number of occasions of need for unknown sizes of finance is in our perspective. This phenomenon is not the same in the pure form of *mudarabah* or *musharakah*. However, perspective is synonymous with the deposit-enterprise outlined above. The deposit-enterprise does not interfere with the longer-run ownership structure of the mother enterprise - the Islamic bank, yet the depositor is fully responsible for the loss of his money. Each PLS deposit is a full-fledged PLS contract. If some funds are withdrawn, the remaining funds in the deposit constitute newer PLS contract and so on.

In the scheme of the PLS proposed in the next sub-section, the concept of the deposit-enterprise has been generalized. Thus each PLS contract apportions ownership among parties. The parties will be responsible for the risk of their respective parts of ownership. But, the ownership of the financier systematically and gradually extinguishes, implying that a single financier will not have any permanent ownership stake in the project. Certainly, some financiers will always be there, but all of them in their perspective, will not hold any permanent ownership in the enterprise.

An anonymous *sharia'h* referee on an earlier version of this chapter, explains the *sharia'h* implication of this arrangement in the following words: "If the enterprise wants to obtain finance from a person without giving him a share in the ownership of his assets it will not be in accordance with the *sharia'h*. However, it may be true that even though the holder of such an instrument will get a share in the assets of the enterprise, yet, because, of the redeemable nature of this instrument, this sharing in the assets will not change the ownership structure of the enterprise in the long run" (emphasis added).
6.4.2 Outlines of the Proposed Redeemable PLS Scheme

It is an irony that despite the academic soundness of the PLS literature, we fail to identify a conceptual scheme for systematically retiring the PLS funds from an enterprise. Specifically, if a bank or an individual investor extends funds to an ongoing enterprise on the basis of *mudarabah*, how these funds will be re-paid after adjusting for losses if any? In the present sub-section, we try to initiate discussion on this issue.

A number of efforts have been made to evolve interest-free financial instruments. Some of these aim to mobilize resources to supplement the available public funds as well as the resources of the Islamic banks. The principle underlying these efforts is similar to the idea of issuing common stocks i.e., these proposals generate non-redeemable, permanent and tradable ownership titles. Hence, the limitations of common stocks as a source of funds (discussed in previous sections) in general apply to these instruments as well. For instance, at a given time, the enterprise in question may consider to issue permanent ownership claims on its assets, to raise funds it needs. The holders of these claims become permanent owners of the enterprise.

The problem arises from the fact that the need for finance is a continuous reality. There is no guarantee that after issuing these shares, the enterprise will not need more finance in the near future. As an ongoing activity, the enterprise must always need more funds. What it should do? Could it issue more permanent claims on its ownership? The simple answer is that such claims can be issued but to a certain limit and this limit is much narrower than often considered in the literature on PLS financing. We discussed the minimal role of stocks in companies capital structure in the industrialized countries. The extreme case is the inability of an overwhelming number of sole proprietorships to go public.

The Proposed Scheme

The example of informal financing can be taken as an illustrative case. Due to the fact that, in the majority of Muslim countries, individual savers as well as small enterprises do not have an access to Islamic banks, informal participation in the capital of the enterprises can enhance investment and growth in these countries. Moreover, these small enterprises are not...
expected to be leveraged, capital participation in them will be consistent with the OIC Fiqh Academy Resolution. Furthermore, a wider scale business interaction between the people is expected to enhance the cherished social solidarity among the Muslims.

Suppose a small sole proprietorship enterprise, is in need of funds, (for instance, $25,000). As the enterprise is sole-proprietorship, these funds cannot be extended on the basis of pure *mudārabah* or *mushārakah*. We propose that these funds can be provided on the basis of redeemable PLS. Suppose, the annual evaluation reveals that at the time of seeking the new funds the total net worth of the enterprise was US $75,000. To this we add US $25,000 contributed by an individual financier, so that the new PLS enterprise with a present value of $100,000 is established. For simplicity, we also assume that on *pro rata* basis the two parties share profits and losses in proportion to their capital contribution. As long as the capital contribution remains in this proportion, the entrepreneur will take 75% of total profits and 25% of total profits will accrue to the financier.

We assume that the entrepreneur is not interested in a permanent partner. The financier also is not interested in tying-up his funds permanently with the enterprise. For his own considerations the financier requires to redeem his funds completely during a specified period, say 5 years. For adjusting cash flows, it is also convenient for the entrepreneur to repay these funds in 5 yearly installments instead of accumulating them for the end of the fifth year.

We assume that both parties complete all formalities which are required for implementing a *mushārakah* contract. In addition, we make the following important considerations.

First, the contract is based on the expected profitability of the entire enterprise rather than an specific activity in it.

Second, to calculate capital growth, the contract recognizes the annual evaluation (audit) reports as a perfect substitute of factual liquidation.
Third, the contract stipulates that in case of profits a certain part say $5000 of the financier's funds will be retired on yearly basis, in case of loss in yearly operations, nothing will be retired and capital will be depreciated proportionately.

In this way, the contract will also specify that PLS contract in the first year will be based on capital contribution in 25% ($25,000), 75% ($75,000) proportion respectively, by the financier and entrepreneur. In the second year, after re-payment of $ 5000, of the principal amount, the capital contribution in the enterprise will change to 20%, 80%; in the third year to 15%, 85%; in the fourth year to 10%, 90%; and in the fifth year to 5%, 95%; finally, the entrepreneur will own 100%. The profits will be shared each year in proportion to the capital contribution relevant for that year. However, with adjustment for losses in some years, this schedule may not be strictly observed.

Fourth, a third party, viz., a Savings' Association administered by the government, may endorse the contract with a guarantee for the yearly repayment of the agreed proportion of the funds contributed by the financier.

Fifth, the contract does not impose any restrictions on the entrepreneur regarding mobilization of funds from other sharia'h consistent sources. However, if the enterprise plans to sell its shares on permanent basis, it cannot do so without first offering the partnership to the financier.

Thus it can be expected that using this mechanism the enterprise can meet its financing needs to expand without involving in ribâ and without compromising its longer-term ownership preferences.

The case can further be generalized. Suppose, the above funds were acquired and the new enterprise established on 1-1-1995 with the present value of $100,000. Since, this enterprise does not restrict the entrepreneur to mobilize additional funds, on 1-1-1996, after the first annual audit report, the entrepreneur may acquire more funds on conditions mentioned above to expand the enterprise further. Thus, a continuous flow of PLS funds can be generated. Retiring funds will thus continuously be replaced by new funds without any rigid conditions imposed on the ownership structure of the enterprise. The door for utilization of
entrepreneurial skills, which is now stagnated, in the Muslim countries, can be made dynamic by removing the financial constraint\textsuperscript{34}.

Following the proposed scheme, the Islamic banks are expected to open line of redeemable PLS with enterprises seeking finance. It is noticeable that at the present Islamic banks extend very short-term mark-up based funds. An important reason for this is the requirement of matching liabilities (deposits) which are mostly short-term in nature, with assets (mark-up funds). As the proposed scheme is biased against issuing stocks and in favor of resorting to direct and redeeming relationship between banks and enterprises, the banks are required to participate at least in the medium term capital of the enterprises. This requires the Islamic banks to mobilize medium and long-term funds to supplement their ordinary PLS deposits.

The banks need to issue financial instruments to raise the required funds. It is a sharia'h requirement that these instruments must be supported by assets which may comprise some debts but should overwhelmingly constitute cash and real assets. Islamic banks' assets overwhelmingly comprise of mark-up based debt, therefore these banks cannot mobilize long or medium term funds by issuing financial instruments. On the assets' side, the involvement of the banks in redeemable PLS is expected to leave them with a much better cash flow and liquidity situation compared to the permanent PLS. This situation will further improve, as a change in the asset structure of the banks would enable them to issue redeemable PLS instruments.

Policy makers in the Muslim countries may benefit from the experience of finance and industry relationship in Japan and Germany. As it is well known, the corporate sector in these countries does not rely much on stocks for financing their growth. Rather, the relationship between banks and industry is much stronger in terms of equity and credit linkages. The banks in turn resort to the market to mobilize funds by issuing long-term bonds. This experience is highly relevant in the framework of the proposed redeemable PLS scheme.

Furthermore, the scheme is also expected to enhance managerial incentives as compared to permanent PLS, as will strengthen internal ownership of the enterprise. In addition, the scheme may also overcome the inevitable domination of the economic system by
financial institutions under the permanent PLS. This matter is of immense importance viewed in context of mobilization of external finance for the resource scarce Muslim countries. As compared to permanent PLS, redeemable does not endanger the host economies to external domination in the longer-run. This aspect is more formally discussed in chapter seven.

6.5 INVOKING SUPPORT FOR THE PROPOSED SCHEME

The proposal to redeem the mudarabah and musharakah funds in installments is knew for the literature on PLS banking. Therefore, critics may raise an objection about the sharia'h permissibility of the proposal. In the present section we argue that although redeemable PLS is not known in the academic literature on PLS financing, its underlying principle has been adapted in a number of contemporary Islamic legislation in different countries. Moreover, some Islamic banks with the approval of their sharia'h advisors have also started issuing redeemable financial instruments.

6.5.1 A Lesson from Financing Awqaf Properties

A waqf is a legal person. Its property cannot be owned but by itself. This implies that the waqf cannot be financed on the basis of the mudarabah. Also, the waqf property cannot be shared by others. This implies that the permanent musharakah also is not a convenient financing technique as the waqf will become a permanent partnership (the waqf may however, manage its current assets with doing short-term musharakas). This financing problem is a typical example of a situation where the need for a comprehensive Islamic financing mechanism outlined in the previous section of the chapter emerges. The example is generally valid. Therefore, a solution put forward to overcome this typical problem, can also be valid for all such cases where generalization of the problem is possible. To overcome the typical problem, the Muqarada Bonds' Act 1981 was introduced by the Government of the Kingdom of Jordan under supervision of a sharia'h board comprised of prominent sharia'h scholars.

Salient features of this legislation which are relevant for the present chapter are as follows: i) Sponsors of a project can avail funds from a financier with a third party guarantee
of the principal amount, ii) The provider of funds, instead of claiming a fixed return on the funds provided, will in fact share in the positive outcome (profits) of the project, iii) The funds provided will be amortized on the basis of the third party guaranteed principal amount and on the basis of shares in profits and an agreed upon formula of amortization which will also be implemented under the guarantee of the third party, iv) Consequently, through a redeemable financial instrument, a financier participates in the capital of a waqf project without interfering in its ownership structure in the longer-run.

It is noticeable that the law was enacted under the supervision of a Fatwa committee. Therefore, a sharia'h evaluation of the legislation is not in the competence of the present chapter.

6. 5.2 A Lesson from Financial Islamization in Pakistan

During the time when the legislation about Muqarada bonds were being incited in Jordan, Pakistan was also making efforts to Islamize its banking and financial system. Regarding, the re-payment of the principal amount of a financial accommodation, another significant contemporary development is the evolution of the concept of Participation Term Certificates. The concept was evolved when the experts involved in the Islamization (led by the Council of Islamic Ideology, Pakistan) of the financial system in Pakistan felt the need to replace ordinary debentures (which are redeemable) with profit and loss sharing alternatives.

For the purpose of this discussion, major features of the PTCs may be highlighted: i) Primarily PTCs are supposed to be the Islamic version of what is known as redeemable capital in the conventional financing practices, ii) PTCs also contain the characteristics of what is known as preferred stocks in the conventional financing practices, iii) As such PTCs will be issued by an enterprise which needs medium and longer-term finance, but for such time horizon, for the value of the finance needed, the firm does not plan to undertake any changes in the ownership structure of the enterprise, iv) The principal amount of the funds as such generated will be re-paid in a specified time period, in specified installments. In addition, the PTC holders will share in the profits of the enterprise as agreed a priori, v) As the principal
amount will start declining due to payments of installments, the proportion of the PTC holders will decline overtime and those of the enterprise will increase, iv) When old PTCs are retiring, the enterprise has the choice to directly invest the increasing amount of the retained earnings in the growth of the enterprise or use them indirectly for the same purpose by issuing new PTCs, and vii) For the purposes of retiring the PTCs, the profits of the enterprise are tax deductible.

However, as practiced by companies under trusteeship of the Bankers Equity Limited, the PTC arrangement of financing has certain objectionable features, such as: i) The assets of the issuing firms are kept as a collateral against the principal amount of the PTCs, ii) The principal amount also includes, the discounted values of the PTC funds for the grace period of the enterprise (if it is new) and iii) In case of loss, the bondholders through their trustee, will have a recourse to the bank accounts and other assets of the issuing enterprises.

**6.5.3 Lesson from Islamic Banks and Mudarabah Companies**

As discussed above, another significant lesson can be drawn from the deposits' side of Islamic banks which represents the most successful contemporary experience of the application of the PLS principle. Similar is the case with mudarabah companies. The calculation and payment of profits to the certificate holders like profit for the depositors does not require a practical liquidation of these companies.

Among the Islamic banks, the practice of Taqwa Bank is of special relevance to support our argument. The scheme of the Taqwa Bank is known as ashum intiyaz qabilatah lil istirdhadh (redeemable preferred shares). An evaluation of this financial instrument is not the purpose of the present chapter. Neither, our purpose is to advertise the particular financial instrument. We however, simply aim to highlight that the sharia'h board of Taqwa Bank (which also included prominent scholars such as al Shaikh Yousuf Al Qardawi), must have evaluated the prospectus of this typical financial instrument. Which implies that redeemability of the PLS funds has been approved in principle.

The contemporary practical cases of the redeemable PLS have in fact opened a new dimension in the field of practicing Islamic principles of financing. There are numerous cases,
where in fact, such a redeemable nature of financing is of paramount importance\(^{39}\). The redeemable techniques of financing have also been suggested as probable Islamic mode of financing for \textit{Awqaf} properties\(^{40}\) as well as for Islamizing the capital structure of the companies\(^{41}\).

6.5.4 Role of the Government

In the proposed and practical cases of redeemable PLS outlined above the principal amount of the finance is almost guaranteed. An objection may be raised against such an arrangement. If the principal amount is guaranteed, the contract would be a \textit{qard} (loan) contract. In such a case, there is no justification for the financiers' share in profits. Provided that there is no third party guarantor such an objection is a valid one. But, a third party (a party having no stake in the enterprise) guarantee for the re-payment of the principal amount of a PLS fund is visualized and legitimized by the Islamic scholars\(^{42}\). Such a guarantee of the principal amount does not transform the character of the contract from sharing to \textit{qard}. If the principal is re-paid as guaranteed, in most contracts, it would be re-paid only in installments.

Due to the third party guarantee, the use of this redeemable financing by large enterprises may be more feasible compared to smaller enterprises. But the actual problem of the elimination of interest also requires an alternative mechanism which can be used by the common people and millions of sole proprietorships. In the absence of any such mechanism, the common people do not have any investment opportunity. Lack of investment motivation can have adverse effects on their savings. Whatever, small savings are made, in the absence of direct investment opportunities, these savings are deposited in the banks. It is well known that these small deposits constitute major sources of the banks' deposits. But on the other hand it is also well known that the banks rarely provide financing to smaller enterprises. Thus, a wide scale use of the mechanism may really revolutionize the process of elimination of interest from the economy.

Both, the cases of the \textit{Muqarada} bonds and PTCs, and for that matter, all bonds require a trustee to protect the interests of the bond holders. Moreover, with the same objective, the bond prospectus, determines the bond indentures. The bond indenture covers
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various aspects of the bond contract in a comprehensive manner so that no party should be harmed. The trustee guarantees the enforcement of the bond indenture. In the case of the Muqarada bonds the Ministry of Awqaf, representing the Government acts as a trustee. In case of the PTCs the Banker's Equity, a public sector, investment bank, representing the Government acts as a trustee. In any case, in the final analysis, the final arbitrator between parties to a contract is always the legal system of a country. In case of the Muqarada bonds, the Ministry of Awqaf, not only guarantees the principal amount, but also guarantees to refund, the outstanding principal amount when ever so desired by the bondholders. For all practical purposes, the Banker's Equity almost functions in similar manner.

To conclude this section, it may be re-emphasized that the concept of Muqarada bonds, PTCs, practices of mudarabah companies, deposit side of Islamic banks, redeemable shares of the Taqwa Bank have consciously been developed to replace the interest-based financing with suitable Islamic alternatives. These experiences suggest that provided the calculation of capital growth is possible, the practical departure of parties of a PLS contract, does not require factual liquidation of the entire enterprise. Moreover, all these arrangements lead to one basic conclusion: that subject to the profitability of the enterprise, the principal of mudarabah and musharakah funds can be re-paid in installments. In other words, a redeemable profit and loss sharing financing mechanism is possible. Since a redeemable financing mechanism does not interfere in the long-run ownership structure of the enterprise, it can serve as a comprehensive financing mechanism as defined in Section Two of the chapter. Thus, it has the potential to be a real substitute to interest-based financing.

6.6 ELEMENTS OF GROWTH OF AN ENTERPRISE

In previous sections of the chapter it is argued that it is possible to visualize a comprehensive financing mechanism in Islamic economics, which can meet the cash requirements of firms without causing any unwanted change in their longer-run ownership structure. The present section intends to argue that such an arrangement is also inevitable for the growth of enterprises under the PLS system.
6. 6.1 Growth: Relationship with Retention and Rate of Return on Equity

Major potential of an enterprise is reflected from its success as an ongoing concern. The most reliable indicator of the success of an ongoing enterprise is its growth over time. The growth of an enterprise is similar to the growth of an economy, seen as one enterprise. As the growth of the economy depends on savings, and efficient utilization of these savings, the growth of an enterprise also depends on two important variables: i) the amount of retained and re-invested resources and ii) the efficiency in utilizing these resources.

Retention is important because the capital base of the enterprise depends on it. In particular, retention is vital for the growth of smaller firms. The reason is simple: There must be some balance between equity and borrowing at all stages of operation and size of a firm. As more funds are needed overtime, all these cannot be met by borrowing without any equity base. But small firms do not always prefer and cannot raise equity easily. For such firms, therefore, profit retention is the sole equity base.

The more an enterprise retains and re-invests, the greater is its capital base, the higher is its potential for growth. Given the capital base, the higher is the rate of return on this capital, the higher would be the growth rate of the enterprise. Growth (g) of an enterprise is thus defined as: percentage of earnings retained (R) times return on equity (ROE); i.e., \( g = R \times ROE \). If \( R=0 \), the capital base of the firm will remain constant, whatever the ROE may be, the growth of the firm would be constant. In the same manner, the ROE is extremely important. If it is zero, R cannot be positive, naturally the growth of the enterprise would not be positive.

Traditionally, there are two methods to look at the ROE: the operational side of the enterprise and its financial policy. The first method uses the operational side of the firm to define the ROE. It implies that the return on equity can be improved, either by producing more - increasing the equity turnover (using the equity more efficiently) or by increasing the enterprise's net profit margin by arranging to become more profitable. Both the two relate to the operation of the enterprise. By using this method, higher ROE will lead to an increase in capital base, only if a non zero fraction of it is retained and re-invested in the enterprise. This way of looking at the ROE is related to the operational side, such as production and marketing policies of the firm.
The ROE however, increases the capital base of an enterprise in a more direct form through its financial policy. The second method expresses the ROE as a result of the financial policy of an enterprise. The ROE can be increased by increasing the capital base of the enterprise by asset acquisition through borrowing. In the traditional sense, therefore, increasing the financial leverage of the enterprise i.e., by acquiring more assets through borrowing, the ROE can be improved.

As this way of expressing the ROE is related to the capital structure of the enterprise, it is relates to the financial, rather than the operational policy of the firm. In the same manner, the decision of profit retention is a matter of the capital structure and financial policy. Thus, being both related to the capital structure of the enterprise, profit retention and this interpretation of the ROE, are consistent with each other - both directly add to the asset-base of the enterprise.

6.6.2 Relative Variability of Retention and Gearing-based Growth

Retention and financial policy component of the ROE (financial leverage of the enterprise) are important factors contributing to the growth of an enterprise. Nevertheless, retention-based growth is more stable compared to debt-based growth. As retention expands the shareholders equity in the enterprise, this leads to the conclusion that equity based growth is more stable than debt-based growth.

Khan (1995) provides mean, median and standard deviation values for self financing, ROE and gearing for various sectors of the Pakistani economy for the 1980-91 period. Based on this data the growth and variability of growth is calculated for the sectors in question. Some observations must be made on this data: i) By definition, industries grew either by high retention, or by high leverage or by both - growth industries such as, the chemicals sector relied less on debt but retained a substantial part of its earnings, paper industry relied more on debt than on retention, sugar depended on high rate of retention. Zero growth industries - textiles and transport borrowed substantially, but their ROE was very low suggesting operational losses, ii) In average, transport, textile, paper and cement industries which relied more on debt experienced unstable growth. Energy is the only sector which relied more on debt but experienced a stable growth, an explanation to be seen in the stable
demand for the products of this sector, iii) In general, therefore, industries relying more on
debt experienced unstable and lower growth, whereas, industries relying more on retention
(shareholders’ equity) experienced stable and higher growth.

6.6.3 Effect of Redeemable PLS on the ROE

An important advantage of mark-up based debt financing is the acquisition of assets,
which in turn, strengthens the ROE of an enterprise. On the other hand, the important
disadvantage of debt financing is its adverse consequences for the financial risk of the
enterprise. Whenever, debt financing is considered, bankruptcy is always possible. So, even
if debt financing enhances asset acquisition, at the time of forced liquidation, these assets can
only be auctioned at throw away prices. In addition, bankruptcy entails other costs. All these
costs are the result of opting for debt. But debt-financing shifts these to the owners of the
enterprise rather than the owner of debts - exposing the enterprise to more and more financial
risks.

So, the fault of debt financing lies in its separation of risks from ownership and
concentrating them on the capital base of the enterprise. A mechanism, which can help
enterprises to acquire assets but at the same time can minimize their financial risks can be
superior to debt. The proposed redeemable PLS arrangement ensures asset acquisition by
the enterprise in the same manner as the mark-up does. But unlike under the debt financing
mechanism, under the redeemable PLS, financiers will not have any fixed claims on the
acquired assets. Thus, the question of bankruptcy and the related costs will not arise. Hence,
the redeemable PLS arrangement has the capability to ensure asset acquisition, i.e., expand
ROE, but without increasing the financial risk of the enterprise.

6.6.4 Effect of Redeemable PLS on Profit Retention

Retention of profits promotes self financing, thus, in general, enables enterprises to
stand more on their own as ongoing entities. In the traditional *musharakah-mudarabah*
contracts, capital contribution by parties and the resultant profit sharing ratios are defined
once for all. The typical example is *mudarabah* in which all funds are provided by one party.
If total ownership of an enterprise is designated as O, where entrepreneur shares O₁ and
financier $O_2$. In the general case of pure \textit{mudarabah}, by definition, $O_1$ is always zero, so that $O_2$ equals one - the enterprise is wholly owned by the financier. For simplicity, let us rely on this general case. This is due to the fact that in its most common practice, the \textit{mudarabah} has been a one transaction business enterprise. At the conclusion of the transaction, growth in the initial capital is calculated for distribution as agreed on pro rata basis. In other words, it is very rare to find historical practical evidence of \textit{mudarabah} as an ongoing enterprise, despite its theoretical possibility.

One great difficulty with the application of the one transaction notion of the \textit{mudarabah} to an enterprise which is ongoing in nature is the fact that due to its ownership structure, single transaction nature and the underlying concept of capital growth, retention of profits is neither relevant nor feasible.

The proof of this assertion is quite simple. First, to make the question of retention relevant, the enterprise itself must be made an ongoing activity. Second, through \textit{tandhid al hukmi} (hypothetical presumed liquidation), the exact cash value of the enterprise must be calculated, capital growth identified, and literally another \textit{mudarabah} enterprise established, with negotiations on profit sharing ratios etc. Each time if retention is considered, the procedure must be repeated. Each time the size of $O_2$ will increase as a result of re-invested profits but $O_1$ will remain zero as implied by the \textit{mudarabah} contract.

There may be entrepreneurs who may not be interested in investing their share of profits in the enterprises managed by them - they may like to deposit it in the Islamic banks. But, the economic and financial rationality of this decision of the entrepreneur can be justified only if they had a free choice to invest or not to invest their savings in the enterprises managed by them. In the absence of this free choice and in the presence of the implied imperfection, entrepreneurial decisions under the prevalent notion of \textit{mudarabah} can best be seen as sub-optimal.

Suppose, the entrepreneur is allowed a free choice to re-invest his savings in the enterprise under his management. Suppose it is a rational decision for him to retain profits and share ownership in the enterprise. Once profits are declared, the entrepreneur must have non-
zero share in the enterprise implying a positive $O_1$, consequently $O_2$ would become fractional. The *mudarabah* is thus transformed into another form of enterprise - *musharakah*. If the process continues, at the extreme, the enterprise will transform into sole proprietorship owned by the owner-manager. Redeemable PLS incorporates this vital consideration and allows for profit retention by the entrepreneur.

It is argued in Section Two that together, the profit sharing and sale principles as substitute of interest are comprehensive principles. Following the same point of view, it may be argued that when a single transaction business activity is in question, the *mudarabah* enterprise must be used. But when an ongoing enterprise is in question, invoking the *mudarabah* enterprise is an injustice to the enterprise itself. In the ongoing enterprises, which are newer than the *mudarabah* enterprise, where required, the profit sharing principle and the sale principles need to be invoked jointly as in the case of redeemable PLS.

Under *musharakah* however, the retention of profits becomes a management decision. This is analogous with the case of joint stock companies. Under these circumstances, profit retention by an enterprise can be enhanced by designing financial mechanism which is biased in favor of retention rather than high distribution of dividends. By definition the redeemable PLS mechanism enhances retention of profits.

### 6.7 ENHANCING CASH-FLOW OF ISLAMIZING ENTERPRISES

It is argued in this chapter that capital participation in enterprises is possible only through the *mudarabah* and *musharakah* modes of Islamic financing. To enhance participatory capital in enterprises, a redeemable form of PLS financing which is more flexible in relation to ownership structure of enterprises is proposed in previous sections of the chapter. The present section aims at discussing the prospects of enhancing the cash flow of Islamizing enterprises. This exercise is also valid for enterprises which look for resource mobilization from the markets in consistency with the *sharia’h*. 
Depending on their attitude to risk, some financiers may prefer capital participation, and others avoid it and resort to mark-up and other fixed return investments. There must also be a wide spectrum of investors whose risk profile require investment opportunities between the two extremes. Moreover, for the purpose of capital participation, some financiers would like to wait and see the outcome of an attempted effort at Islamization of the capital structure of an enterprise. If these propositions are true, there is a need for financial instruments which can meet the preferences of the wide group of investors. Hence, enterprises can also attract more participatory capital from financiers by attaching incentives with their requests for the installment purchase mode of financing.

While the argument is valid in general, it can be clarified better by taking the case of a joint stock company. Suppose a joint stock company has been in the stock exchange or over the counter market for sometime. The current market value of its share is dollars 9 which is depressed compared to the prices of similar other companies and its own previous prices. The enterprise needs a major re-structuring, including the replacement of interest-based debts, for which substantial finance is required. Provided the re-structuring is undertaken, the growth prospects of the enterprise are high. The expected growth if achieved will lead to an increase in the value of the enterprise i.e., its stock prices will increase in the future. However, given its prevailing circumstances, the enterprise cannot raise funds by selling more stocks. As its prices are already depressed, it cannot issue more stocks as such an action will put more downward pressure on the prices. Moreover, there is an interest-based debt in its capital structure which drives away the Islamic investors.

The enterprise can however raise finance by deferred or more specifically installment purchase arrangements. This mechanism relieves the enterprise's presently available funds for more urgent uses improving its cash flow conditions indirectly. The more flexible the re-payment schedule, the better its implications for the cash flow of the enterprise. Hence, in general, enterprises bargain on prolonging the re-payment period as it improves their cash flow conditions. It is natural that the longer the re-payment period, the higher the mark-up is expected to be. Thus it is natural for enterprises to seek installment purchase financing for a longer period but at the lowest possible mark-up.
In its prevailing depressed circumstances the typical enterprise cannot also raise installment purchase financing at a suitable mark-up. In fact, the enterprises need long-term funds. Suppose, the enterprise can be made profitable if installment purchase worth dollars 10 million can be made available at 6% mark-up with a maturity of 15 years. The financiers are willing to provide the required financing with the required time of maturity, but only at 11% mark-up.44

How to raise the financing which is required to make the enterprise profitable? Or more specifically, how to motivate the financiers to provide the required amount at the required mark-up for the required time? In order to secure the required funds, two flexible options among many possibilities may briefly be discussed here: i) An offer to purchase the common stock of the enterprise by the financier and ii) An offer to convert the liabilities of the installment sale into common stock of the enterprise.

7. 7.1 The Option to Purchase Common Stock

To get the required finance at the required conditions, the enterprise can bargain with the financiers. As a part of this bargain, the enterprise may offer an open option to the financiers to purchase the common stock of the enterprise in future at a price specified at present (the time of the contract). As the present market value of one share is dollars 9, it will be specified in the contract that if he so desires, the financier can buy a specified amount of common stock from the enterprise at suppose, dollars 12 per share during a specified future date. It may be noted that The OIC Fiqh Academy Resolution concerning Muqarada bonds permits some form of future promise, provided it is binding on only one party. In the present case, the option to purchase is not binding on the financier, but the promise to sell is binding on the enterprise. Thus the proposed contract, in spirit, does not seem to violate the resolution.

There are several justifications for putting the future offer price higher than the present market price. First, the owners of the enterprise have the right to fix the price of their property. Second, by raising the asset base of the enterprise with the responsibility for the dollars 10 million installment purchase liabilities, the future price of the enterprise must be...
higher compared to the price prevailing prior to the addition of this amount. Lastly, the financier is at its free will to purchase or not to purchase in the future.

Both the parties are expected to benefit from this arrangement. The enterprise urgently needs the funds for improving its efficiency. It receives the required finance for the required period. Moreover, it has the benefit to sell its stocks at a higher price. It is noticeable that without the offer, the sale of stocks would have further depressed the value of the enterprise, but with the offer, the stock has the possibility of sale at a higher price. Moreover, till actually purchased, the offer does not carry dividend claim. Furthermore, till the stock is actually purchased, the offer also does not claim votes for the control of the enterprise. In addition, these relieve the enterprise from corporate income taxes. Hence, the offer arrangement has several clear benefits for the enterprise.

By considering the offer as an investment avenue, the financier considers an opportunity to invest in a real project. The expected growth potential of this enterprise is high. The stock which the investor will buy at dollars 12 may thus be sold at further higher prices in the future. Moreover, by buying these stocks, the financier will actually be pumping more cash into the enterprise, improving the prospects of the enterprise to pay the installment purchase liabilities more efficiently. The financier would also avoid the dividend taxes which he must pay in case of outright purchase of such stocks which announce dividends. The financier can also motivate the firm to replace interest-based debt from its capital structure, thus enhancing Islamic investment opportunities.

7.7.2 The Option to Convert Liabilities into Common Stock

The second point at which the enterprise can bargain with the financier for favorable conditions of financing is the option to convert the installment purchase liabilities into common stock of the enterprise. Again, at the time of the initial contract, the enterprise may offer to the financier that at his own will the financier may convert a specified part of its liabilities into the common stock of the enterprise at a specified higher price compared to prevailing market price.
It may be noted that this proposal resembles a situation where debt is considered as a principal in *mudārabah/mushārakah*. The *sharia'h* scholars have discussed this issue in detail. All *shari'ah* scholars reportedly do not agree with this arrangement. However, if it is said that “collect that debt and do *mudārabah* with it”, it is reportedly acceptable to the Hanbalites and Hanfites. Some Hanbalites even went to the extent that the indebted person can collect the debt from himself and do *mudārabah* with it. The concern of the scholars who disapprove this arrangement is understandable in case the indebted person is an individual and his net worth is not clearly known. But in case of an established enterprise with a known asset base, an enterprise to which the financier itself has sold on installment credit, the flexibility of the scholars who permit the arrangement seems to be more useful.

Our point can be further strengthened by developing a different scenario. Suppose the financier finances the purchase of an asset on installment purchase or *istiṣna‘* basis. As a result, the user of finance owns the asset and the financier owns the resultant debts. Assuming that after making 40% of the debt payments, the owner approaches the financier to buy the remaining 60% against the outstanding debts. If the financier buys, the resultant new enterprise would be a 60:40 *mushārakah*. As debt can be used as a price in a spot transaction, this arrangement is expected to be fully acceptable to all *shari‘ah* scholars. A brief comparison of this situation with the general case discussed by the *shari‘ah* scholars is provided in Exhibit 6 (c). It is clear that the debt created by deferred sale has at the same time transferred ownership which can be verified easily. The other debts may do not necessarily transfer assets. This is an important difference between mark-up based debt creation and other means of debt creation.
### Exhibit 6 (c): Causes of Indebtedness, Counter-Value of Debt and Possibility of Using Debt as a Capital of *Mudārahah*

<table>
<thead>
<tr>
<th>Causes of indebtedness</th>
<th>Resultant asset of owner of debt</th>
<th>Resultant assets of the indebted person/party</th>
<th>Control of Counter Value of Debt</th>
<th>Possibility of using debt as a principal of <em>mudārahah</em> or <em>mushārahah</em></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bay’ (Sale)</td>
<td>debt</td>
<td>physical asset or services</td>
<td>always possible</td>
<td>In general, debt cannot be the principal of <em>mudārahah/mushārahah</em>.</td>
</tr>
<tr>
<td>Qard (Loan)</td>
<td>debt</td>
<td>money or goods</td>
<td>not always possible</td>
<td>However, for both Hanafis and Hanbalis, debt in responsibility to collect from others can be; example: collect that debt and do <em>mudārahah</em> with it.</td>
</tr>
<tr>
<td>Taking responsibility to collect debt from others</td>
<td>debt</td>
<td>debt or goods</td>
<td>not always possible</td>
<td>For a few Hanbalis scholars the indebted person can take responsibility of collecting the debt from himself.</td>
</tr>
<tr>
<td>Taking responsibility to collect debt from oneself</td>
<td>debt</td>
<td>debt or goods</td>
<td>not always possible</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>Unpaid contractual obligations, such as accumulated debts, unpaid accruals, financial obligations as a result of legal proceedings, etc.</td>
<td>debt</td>
<td>debt or goods</td>
<td>not always possible</td>
</tr>
</tbody>
</table>
The benefits of our proposed arrangement for the enterprise are the same as in the case of an option to purchase the common stock of the enterprise, except that this arrangement does not improve the cash flow situation directly. But since it improves the equity base of the enterprise, the enterprise can raise more financing easily. Hence, cash flow of the enterprise is indirectly improved. The advantages for the financier are almost the same as discussed in the previous case.

Since, both parties are likely to benefit, the society as a whole will be benefited from the arrangements. Moreover, the arrangement has also introduced a certain degree of risk sharing into the installment sale financing. Furthermore, it opens a flexibility for capital participation by the Islamic investors. An Islamic bank which provides the installment sale facility, before utilizing the options can wait and ensure the abolition of interest-based debts from the capital of the enterprise. Indeed, these considerations offer many interesting possibilities which can only be postponed for separate studies.

The above considerations wait careful evaluation as the area of options is not yet properly discussed in the Islamic economic literature. While the two options apparently do not appear problematic, both have several unknown implications. Some of these unknown implications are raised here, whereas, the full discussion of these issues may require separate research chapters.

First, both the two methods are prone to generate markets. For, example, instead of utilizing the option for actually purchasing the stock, the financier may be prompted to sell the option. It must be noted that according to an OIC Fiqh Academy resolution, an option is not negotiable. Could there be such a market? How to regulate it?

Second, for several reasons, the enterprise may be prompted to call back the two options. At what price and conditions?

Third, how to determine the actual conversion prices, in particular, if a market for such options is restricted.
Fourth, in both the two options, the stock prices may exceed the prices which can maximize the value of the enterprise. Therefore, enterprises are prompted to split the stocks (e.g., if the price of a share is $80 which is considered very expensive by many investors, the enterprise will split one share into two $40 each) so that many investors can buy the shares and maximize the value of the enterprise. What will be the effect of this on the two options?

Fifth, similarly, many growth oriented enterprises (like the one in question) for the same considerations of high stock value, offer additional stocks in place of dividends. The effect of such decisions on the two options are not known.

Sixth, many enterprises (in fact a rapidly growing number of them) often decide to re-purchase their own stock to invest the retained earnings. Such arrangements in fact support the stock price and may not directly harm the interests of the option holders. Nevertheless, this is a decision, if known to the financiers in the beginning, could have affected their financing decision.

These and other consequences of the two options are unknown. Despite that these considerations are of significant importance for easing the access of enterprises to various flexible and efficient financing arrangements, at the same time, enhancing the participatory financing arrangements. Traditionally, to meet the preferences of investors in various risk categories portfolio diversification is adopted. Portfolio diversification eliminates risk aversion, pushing the rate of return on the portfolio (the cost of capital) up, hence leads to inefficiency from the macro perspective. Compared to portfolio diversification strategy, the above considerations for meeting the preferences of various investors seem to be more efficient as the fixed return financing is subordinated to participatory financing.

Nevertheless, these and related issues which constitute an important aspect of the Islamic corporate finance are yet undiscovered in Islamic economics. The prohibition of interest, and in its place, the evolution of a real Islamic substitute requires a thorough investigation into these and related areas of corporate finance.
6.7.3 Managing Accounts Receivables

Firms are not pure financiers but for expansion of their sales cannot also avoid credit sale. The cash conversion process thus effects the cash-flow and liquidity position of the firm. It has an implication for the growth opportunities of the firm as summarized in Exhibit 6 (d).

Exhibit 6 (d) Growth Possibilities Without External Financing

<table>
<thead>
<tr>
<th>(1) Firms</th>
<th>(2) Inventory conversion period (numbers per year)</th>
<th>(3) Receivable collection period (numbers per year)</th>
<th>(4) Payable deferral period (numbers per year)</th>
<th>(5) Cash conversion cycles (2+3-4)</th>
<th>(6) Net profit margin (%)</th>
<th>(7) Growth possibilities without external financing (5*6) %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>1</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>2</td>
<td>2</td>
<td>2</td>
<td>2.25</td>
<td>1.75</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>4</td>
<td>2</td>
<td>2</td>
<td>4</td>
<td>0</td>
<td>4</td>
<td>0</td>
</tr>
</tbody>
</table>

Exhibit 6 (d) shows that growth possibilities with no external financing depend on cash conversion cycles of the firm and its net profit margin. Given the firm’s net profit margin, growth possibilities can be enhanced by making the firm’s cash conversion efficient. This can be done by reducing the average annual time of the firm’s inventory conversion and receivable collection periods on one hand and increasing the time of its payable deferral periods on the other. These three periods can be managed directly as well as can be used as a basis for generating additional funds to improve the firm’s cash flow.

Narrowing the Cash Conversion Cycle by Financing

The average time for the inventory conversion and accounts receivable period can only be narrowed within the limits of certain constraints. In addition, firms use inventories and accounts receivable to mobilize additional funds to enhance their cash flow. Both inventories and accounts receivables are part of the firm’s assets in place. As such, often these are either sold or used as pledges to borrow additional funds.
Exhibit 6 (e) shows the growth possibilities with and without the transfer of accounts receivables. Suppose the firm has SR 5 million accounts receivable with a cash conversion cycle of 2 per year. The net profit margin is 4%, hence possible growth in the next year is 8% (2*4). We assume that the receivable are transferred to a financier at an amount of SR 4.75 million instead of SR 5 million. Assuming that this arrangement enhances the cash conversion process to 2.3 per year from 2, but at the same time reduces the net profit margin to 3.75% from 4%. The new growth possibility with the transfer of accounts receivable would then be 8.63% (2.3*3.75) as compared to 8% without the transfer. In this case, growth possibilities of this firm are increased by .63%. The transfer process, although may reduce the net profit margin, but would enhance growth possibilities by improving the cash conversion process. This would not only offset the reduction in net profit margin, but would also accelerate future growth by the investment multiplier process.

### Exhibit 6 (e): Growth Possibilities With the Involvement of a Financier

<table>
<thead>
<tr>
<th>Presence of Bank</th>
<th>Value of Accounts Receivables (million Riyals)</th>
<th>Yearly Cash Conversion Cycles</th>
<th>Net Profit Margin %</th>
<th>Growth Possibilities %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without</td>
<td>5</td>
<td>2</td>
<td>4</td>
<td>8</td>
</tr>
<tr>
<td>With</td>
<td>4.75</td>
<td>2.3</td>
<td>3.75</td>
<td>8.63</td>
</tr>
</tbody>
</table>

A Proposed Islamic Scheme for Managing Accounts Receivable

We start with a normal case where a client makes orders to the firm for shipment of goods, suppose worth SR 5 million. We assume that as a normal case, the orderer does not pay in advance, rather asks invoices for payment. The payments will be made upon receiving the invoices and consignment. After making the shipment, the invoices are entered in the accounts receivable of the firm as assets. But, it would take time for receiving the cash against the invoices. Considering the fact that most sales of the firm take this pattern, given the level of sales, the cash conversion cycle is a crucial consideration for the firm.

The firm benefits from shortening the time lag between the actual shipment and invoice date and receiving the cash - reducing its cash conversion cycle. One effective method of managing the accounts receivables to reduce cash conversion is factoring. As factoring involves dealing in interest, a shari’ah observing firm has to find an alternative for factoring. We suggest that as soon as the purchase order for SR 5 million is received, the selling firm
approaches its bank and offers the same goods at 4.75 million on the condition that the bank will immediately transfer the cash in the firm’s account.

As a result, the firm will receive cash and there would be no accounts receivable for this sale. The relationship between the bank and the purchaser is irrelevant as for the cash flow of the firm is concerned. However, it is useful to make some observations on this relationship too. If the purchaser holds an account with the bank, the invoices may be charged against that account and there would also be no accounts receivables for the bank for this operation. Normally, the operation must require such an account. However, if the purchaser has no such account with the bank, the SR 5 million will be recorded by the bank as accounts receivables. The purchaser will owe the bank the SR 5 million.

We understand that this arrangement can be institutionalized so that the three parties know each other’s obligations. For example, the bank can be chosen with the consent of the purchaser so that the goods are in fact sold to him.

Trade-Off Between Profit And Growth Opportunities

The proposed scheme to manage accounts receivables from an Islamic perspective is open to an important criticism - by selling at SR 4.75 million to the bank, instead of at SR 5 million to the orderer, the firm is actually reducing its net profit margin proportionately. On its account, this criticism is valid. But such a decision of the firm can also be rationalized under normal operational conditions as noticed from Exhibit 6(b) that there is a trade-off between growth opportunities and net profit margin.

1 Durable asset participation is another form of risk sharing through allocation of rentable assets instead of funds.
2 The authors of the report on Islamization of the financial system in Pakistan also treat profit sharing as the foremost alternative for the interest-based financial system. See Council of Islamic Ideology Pakistan (1981).
4 In its 7th Session held in Jeddah, 7-12/11/1412H (May 9-14, 1992), the learned Fiqh Academy formally considered the legal status of Islamic banks’ owning shares of such companies’ whose capital structure includes interest-based funds and the resolution was made that: "...it is originally unlawful to participate in companies dealing sometimes in unlawful things, like interest etc.; despite the fact that their activities are basically lawful". This resolution was reiterated in the recommendations of the seminar on Problems of Islamic Banks, jointly organized by the Academy and IRTI, held in Jeddah during 22-10-1413H (14-4-1993).
In this regard, the IDB has initiated a Pilot Project of replacing interest-based capital with Islamic alternatives in some of the companies where the IDB has an equity stake.

It should be noted that all debts of an enterprise may not be interest bearing as some of these may be due to *qard* (interest-free loans) and some may be the result of a deferred purchase arrangement such as mark-up and others may be due to accrued rents.

Although this method is suggested in IDB (1994), *Shari'ah* objections are raised against such arrangements.

See IDB (1994).

The word "pure finance", is more suitable instead of "comprehensive financing mechanism". Nevertheless, due to an objection of a colleague, on the use of the previous word, throughout this chapter the latter phrase is used.

Installment purchase and leasing can however indirectly be instrumental for the cash flow adjustment as funds which could otherwise have been used for the purchase of assets can be released.

To illustrate this point, we may refer to the pre-revelation *mudāraba* enterprise between Lady Khadijah and Prophet Mohammed. As the story is narrated, Khadijah was a pious rich lady. She needed a pious and honest manager for her funds. Mohammed was approached to manage these funds through a *mudāraba* enterprise. The point is that the *mudāraba* was initiated as an enterprise for managing surplus funds rather than for financing a deficit. But this enterprise, financed the utilization of the entrepreneurial talents of Mohammad. It naturally implies that *mudāraba* inevitably leads to the establishment of an enterprise.

Actually people need resources not money as such. The provision of resources with deferred payment arrangements serves the purpose of finance. But, here we are talking about financing in the general sense, where money only is relevant.

An interested reader may refer to Siddiqi (1983) and Chapra (1986) for how by removing the collateral requirement, the PLS can encourage small enterprises on mere efficiency grounds, to Khan (1992b) how profit sharing is conducive to human resources development.

Islamic economists also argue that the social security system provided by *zakāh* will provide a shield against such risks.

According to the Small Business Administration Department of the US Government, 98% of all business in the US is considered as small, these provide about 60% of total US business employment, 100% of new jobs in US industry, these enterprises innovated more than half of all US product and service innovations since the early forties. For more details see Brigham, (1992).

The flotation cost is estimated as 4% for offerings worth more than US $50 million and 21% for offering up to $1 million. Given the same rate of dividend payout the cost of equity for the smaller firm is 19% compared 15.6% for the larger firms. In addition the market rate of return on stocks of smaller firms is also reported to be high - the market also charges more. See ibid.

Although in the framework of the present chapter it is irrelevant to ask sole proprietorships to opt for *mudāraba* or *mushārakah*, some recent empirical studies confirm this proposition. See al Hajjar and Presley, (1996) for the preferences of these enterprises for mode of financing in a capital surplus country. Also see Ahmad (1990) for the lack of preference of firms in a capital deficit country.

Interest-free loans are the most effective form of finance. Such loans do not disturb the sole proprietorship structure of an enterprise. In context of the birth of sole proprietorships in Japan and their rise into multinationals, the importance of interest-free funds is often considered as a predominant factor. Interest-free loans may equally be effective in the developing Muslim countries. Nevertheless, the existence of a return-free mechanism does not necessarily impose a restriction on the Islamically legitimate return bearing informal financing mechanism.

For an updated review and comparison of the competing theories one may refer to Brigham (1992), and Kelly (1989).

The robust signaling theory advises that investors should suspect the intention of large corporations whenever these issue new stocks. Because, if the prospects of the corporation were good, why should corporations share it with stockholders? Conversely, they will only try to share the bad prospects of the enterprise. In other words, if the prospects are good they will borrow and if bad issue stocks!

22 Keynes is reportedly used to resemble stock markets with "casinos", on his views and an interesting discussion on the role of stock markets in economic development, see Sing (1993). Also see Allais (1993) on the speculative moves in the stock market, the damage caused by it and the proposed reforms. For the views of Islamic scholars on the subject one may refer to al Qari (1993).


24 Sing (1993) refers to a MIT study on the subject of competitiveness of US and Japanese industries. The MIT study concludes that as a result of diversification - seeking higher rate of return, the US firms have lost competitiveness to the Japanese.

25 To illustrate the importance of this point, we can compare hypothetical transaction specific mudarabah contracts. Different modarabas may deal in the same merchandise and involve the same amount of funds. Yet some of these may convert goods into cash, liquidate faster than the others. Demand conditions, efficiency of the mudarib etc., will contribute to the difference in the time needed for the cash conversion process. Whereas, in the second case, the two parties are forced to stay in their contractual relationship unless the merchandise is sold. The other option for the owner of funds is to enforce premature liquidation. In this case, the unsold goods will be treated as scrap, the owner of funds has to accept a lesser evaluation of the enterprise and incur a loss. This implies that factual liquidation of an enterprise is needed to enable the parties to depart.

26 Tandhid al hukmi is used by the Islamic banks for the purposes of fulfilling mudarabah conditions of actual liquidation for distribution of profits. In ongoing enterprises since the principal amount remains in active utilization, its ultimate growth is only a matter of forecast rather than actual. To offset any ultimate negative growth in these funds a reserve fund is recommended by Islamic scholars. See Chapra (1985)

27 It is noteworthy that newer explanations of the firm's capital structure rely mostly on the relative implication of different forms of funds for the firms' cash flows.

28 For a detailed study of the differences between traditional mudarabah and contemporary mudarabah (deposits' side of Islamic bank), one may refer to al Amin (1991).

29 We also need to keep in record that al Jarhi (1976) calls for a 100% reserve requirement. Fahmi (forthcoming) calls for the complete abrogation of the present deposit mobilization mechanism of the Islamic banks to conform it with the original principle of mudarabah. In this chapter we do not aim to discuss this particular issue. Suffice it to emphasize that the deposit mobilization techniques of Islamic banks are almost uniform and it has the approval of the consensus of Shariah scholars.

30 It shall be noted that Islamic banks have different types of PLS deposits, such as specific purpose and general purpose etc. But in general, all these deposits can be withdrawn at wish (See, e.g., Ahmad 1993).

31 For example, M. El-Hennawi, (1993) proposed investment certificates as permanent ownership titles on specific projects. The idea of leasing certificates being formally developed in Kaif (forthcoming) is another example in the same lines. Revenue sharing bonds as interest-free project financing techniques were innovated and patronized by the late President Turgut Ozal of the Republic of Turkey. Zarqa (1990) proposed istisna certificates for financing the social infrastructures according to the Islamic requirements.

32 The existing literature on informal finance in the capital scarce developing countries gives the impression that interest-based informal lending exists in all developing countries including Muslim countries. This author has discussed the matter with relevant researchers from India, Pakistan, Bangladesh, Sudan, Algeria, Tunisia, and Egypt. All maintain the position that some Muslims, though use interest-based institutional finance, however, do not charge interest on inter-personal loans.

33 For these conditions, one may refer to Omar (1992)

34 It must be emphasized that we are not offering any panacea. But we notice in Pakistan that excess liquidity has been termed by the State Bank as the number one problem of the economy. One reason of
this phenomenon is the non-availability an appropriate financing mechanism. The moral conditions of the people of Pakistan may not be ideal. Even with these conditions it is almost impossible to find interest-based informal funding. Thus, our attempt is a merely an effort to open a dialogue in the direction of evolving a comprehensive financing mechanism.

For more details of the legislation, see Khairallah (1986).

However, one may refer to the OIC Fiqh Academy Resolution regarding Muqarada Bonds for Shari’ah observations on the legislation.


al Amin (1990) discusses several of these issues from the Shari’ah perspective.

For more details see BenDjilali and Khan (1995).

See IDB (1987).

IDB (1994).


For arguments on the efficiency signaling role of dividend payments, the reader may like to refer to the voluminous literature on the subject of dividend policy of the firm. However, in the present chapter, we are using the premises which argue for profit retention.

Among other things the mark-up rate can depend on the re-payment time. For example, in the IDB the mark on finance provided under the Import Trade Financing scheme where the repayment time ranges between 9 to 24 months, the mark-up ranges between 6-6.5%. While under the installment sale scheme, the where the repayment takes up to 12 years, the mark-up ranges between 7.5-8.5%. Whereas, under both schemes a rebate of 15% is given out of the outstanding mark-up for quick repayment (See IDB Brochures on the two schemes, both dated September 1993).

See Al mausua’ al fiqhiyah, Kuwait: Ministry of Awqaf and Islamic Affairs, Introductory Publication, Vol. 10 pages 24-25.
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Tariqullah Khan 1996