Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?

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Abstract: Proponents of Islamic financial institutions (IFIs) regard their conventional counterparts as Islamically unacceptable, because the latter are interest-based, not based on fair profit-loss sharing (PLS) and risk sharing. Idealization of the PLS mode is questionable as it is not explicitly mandated in Islam's primary texts. The preference for PLS is based on juristic interpretation that evolved in response to the prohibition of *ribā*, commonly equated with interest. Contrary to theory, IFIs in practice have marginalized PLS modes and instead adopted mark-up type, interest-substituting, risk-avoiding modes of finance. In this paper it is argued that despite the theoretical idealization, IFIs as businesses are rational in avoiding PLS modes. Partnership is the least common form of business organization for practical reasons. In this context these reasons also cover equity-financing. IFIs are organized as banks, but rather than being financial intermediaries, they are primarily merchant banks. Accordingly, this paper contends that legally restricting or religiously idealizing PLS modes is untenable. The conclusion is that, while paying lip service to PLS modes to define themselves as interest-free *aka* Islamic entities, IFIs continue to marginalize PLS, packaging conventional banking products under Islamic labels.

I. Introduction

The Islamic Banking and Finance (IBF) movement has become a rapidly expanding phenomenon in the Muslim world. It is also drawing attention and serious involvement of major Western financial powerhouses. The crux of the IBF movement is the Islamic prohibition of *ribā*, which orthodoxy equates with interest in general. To avoid interest completely as its central

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allocation tool, IBF has developed an impressive array of transactions modes claimed to be based primarily on profit-loss-sharing (PLS) modes. "Since *ribā* was defined as interest, Islamic banking became synonymous with interest-free banking. The prevailing belief was that interest-based banking would be primarily replaced by profit-and-loss sharing (PLS) schemes" (Warde, 2000: 75–76).

PLS modes seek to avoid debt-financing and use partnership and equity-financing, similar to venture capitalism. Paradoxically, while the pertinent literature continues to emphasize PLS as the main modes, in practice Islamic financial institutions (IFIs) have deliberately and systematically avoided them. PLS modes are often presented as variant forms of partnership financing. This paper contends that there is a serious problem with the partnership framework, in which equity-financing is considered. The problem stems from the very nature of partnership as a legal form of business organization. It is further argued that without modifying various contractual aspects of equity-financing, it is economically rational for IFIs to use predominantly debt-like instruments, while claiming Islamicity on the basis of almost non-existent PLS modes.

II. Idealization of the PLS Mode in Islamic Finance

One key precept of Islamic finance is that under conventional systems based on interest, neither profit and loss nor risk is shared by the contracting parties. This is evidenced in the following statements:

> [T]he instrument of interest has a constant tendency in favour of the rich and against the interests of the common people. The rich industrialists, by borrowing huge amounts from the bank, utilize the money of the depositors in their huge profitable projects. After they earn profits, they do not let the depositors share these profits except to the extent of a meagre rate of interest, and this is also taken back by them by adding it to the cost of their products. Therefore, looked at from macro level, they pay nothing to the depositors. While in the extreme cases of losses which lead to their bankruptcy and the consequent bankruptcy of the bank itself, the whole loss is suffered by the depositors. This is how interest creates inequity and imbalance in the distribution of wealth. (Usmani, 2002: 113)

> Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance. Broadly, PLS is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit and loss. Most

> Islamic economists contend that PLS based on two major modes of financing, namely *Muḍārabah* and *Mushārakah*, is desirable in an Islamic context wherein reward-sharing is related to risk-sharing between transacting parties. (Dar and Presley, 2000: 3)

> The most important feature of Islamic banking is that it promotes risk-sharing between the provider of funds (investor) and the user of funds (entrepreneur). By contrast, under conventional banking, the investor is assured a predetermined rate of interest. Since the nature of this world is uncertain, the results of any project are not known with any certainty *ex ante*, and so there is always some risk involved. In conventional banking, all this risk is borne by the entrepreneur. Whether the project succeeds and produces a profit or fails and produces a loss, the owner of capital gets away with a predetermined return. In Islam, this kind of unjust distribution is not allowed. In Islamic banking both the investor and entrepreneur share the results of the project in an equitable way. In the case of profit, both share this in pre-agreed proportions. In the case of loss, all financial loss is borne by the capitalist and the entrepreneur loses his labour. (Iqbal and Molyneux, 2005: 28)

To remedy the alleged harms from interest-based arrangements, orthodox Islamic finance argues that financing should be based on a fair sharing of profit/loss and risk. The financing/business forms that are claimed as the model Islamic forms are *Muḍārabah* and *Mushārakah*.

The IBF movement began by identifying *Muḍārabah* (investment partnership involving (a) active or managing and (b) silent or capital-contributing partners) and *Mushārakah* (partnership in general) as the two primary modes of operation. "The most important feature of Islamic banking is that it promotes risk-sharing between the provider of funds (investor) and the user of funds (entrepreneur)" (Iqbal and Molyneux, 2005: 28). According to Muhammad Taqi Usmani, one of the leading *Sharīʿah* experts, who also serves on the boards of different Islamic banks or banks with Islamic operations, "The real and ideal instruments of financing in *Sharīʿah* are *mushārakah* and *muḍārabah*" (Usmani, 2002: xv). The author adds about *mushārakah*:

> *Mushārakah* is a specific form of *shirkah*, which means 'sharing' of various kinds, including *shirkat al-milk* ("joint ownership of two or more persons in a particular property"), *shirkat al-ʿaqd* ("a partnership in business effected by a mutual contract"). *Mushārakah* "has been introduced recently by those who have written on the

> subject of Islamic modes of financing and it is normally restricted to a particular type of *shirkah*, that is, the *shirkat al-amwāl*, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *shirkat al-aʿmāl* also where partnership takes place in the business of services. (Usmani, 2002: 5–6)

III. Praxis of Islamic Financial Institutions (IFIs): Rhetoric vs. Reality

Even though PLS modes are idealized in Islamic finance, in reality they are seriously marginalized in IFIs.

> Almost all theoretical models of Islamic banking are either based on *Muḍārabah* or *Mushārakah* or both, but to-date actual practice of Islamic banking is far from these models. Nearly all Islamic banks, investment companies, and investment funds offer trade and project finance on mark-up, commissioned manufacturing, or on leasing bases. PLS features marginally in the practice of Islamic banking and finance.
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> Whatever is the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their business. Even specialised Islamic firms, like *Muḍārabah* Companies ... in Pakistan, which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a *Muḍārabah* or *Mushārakah* basis. According to the International Association of Islamic Banks, PLS covered less than 20 percent of investments made by Islamic banks world-wide (1996 figures). Likewise, the Islamic Development Bank (IDB) has so far not used PLS in its financial business except in a few small projects. (Dar and Presley, 2000: 3)

Instead, IFI have turned predominantly to *Murābahah*, a mode that ensures maximum risk avoidance and a relatively high return. *Muḍārabah* and *Mushārakah* have been found to be inoperable in the modern context (see, Saeed, 1996: 6–95; Aggarwal and Yousef, 2002: 106; Vogel and Hayes, 1998: 7). Vogel and Hayes (1998: 141) observe: "While the distinction from a mere loan is compelling in theory, in practice Islamic banks often employ various stratagems to reduce their risks in *murābaḥah* almost to zero, particularly in international trade." Thus, the banks have quietly disengaged from the PLS/risk-sharing modes and embraced *Murābaḥah*, which is described by many as "*murābaḥah* syndrome: the strong and consistent tendency of Islamic

banks and financial institutions to utilize debt-like instruments" particularly in external financing (Yousef, 2004: 65). Saeed (1996: 87) further explains:

> *Murābaḥah*, which is the dominant method of investment of funds in Islamic banking is, for all practical purposes, a virtually risk-free mode of investment, providing the bank with a predetermined return on its capital. As the Council of Islamic Ideology Report recognizes, in *murābaḥah* there is the possibility of some profit for the banks without the risk of having to share in the possible losses, except in the case of bankruptcy or default on the part of the buyer.

Interestingly, Siddiqi, a leading proponent and expert on Islamic economics and banking, asserted in his earlier writings in the 1980s: "For all practical purposes this [the mark-up system or *Murābaḥah*] will be as good for the bank as lending on a fixed rate of interest" (Siddiqi, 1983: 139). Noting some international and national statistics that illustrate the seriously skewed distribution of wealth, Sufyan Ismail writes: "Any neutral observer can see the problems the above [capitalist banking] system causes on a macro basis in any economy. Islamic finance operates a system called *Mushārakah* which ensures that the above inequalities do not occur... *Mushārakah* lies at the heart of the Islamic Financing philosophy, where the notion of sharing in risk and return between investors and entrepreneurs finds its natural home" (Ismail, n.d.: 16, 21) The same viewpoint was clearly echoed in *The Text of the Historic Judgment on Interest* by the Supreme Court of Pakistan (See Section 190, 'Mark-up and Interest'): "The Council has in fact suggested that the true alternative to the interest is profit and loss sharing (PLS) based on *Mushārakah* and *Muḍārabah*".

Siddiqi (1983: 52) went much further to warn the Islamic finance industry:

> ... we cannot claim, for an interest-free alternative not based on sharing, the superiority which could be claimed on the basis of profit-sharing. What is worse, if the alternative in practice is built around predetermined rates of return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provided in the modes of finance based on *murābaḥah*, *bayʿ salam* (a forward sale, whereby payment is made at time of contract and item is delivered at later), leasing and lending with a service charge, are all predetermined as in the case of interest. Some of these modes of finance are said to contain some elements of risk, but all these

> risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around these modes of financing can hardly claim superiority over an interest-based system on grounds of equity, efficiency, stability and growth.

Nevertheless, criticism of *murābaḥah* may have been overstated because, as the proponents of IBF argue, mark-up or cost-plus type transactions are permissible in Islam. Yet, permissible *murābaḥah* is in sales, not in financing transactions. In vogue only since the 1970s (Siddiqi, 2001), modern *murābaḥah* combines sales and financing as part of one transaction. Can Muslims still not deviate from classical Islamic law? Of course, they can. And, indeed, much of modern Islamic banking is based on significant reformulation of classical laws. Islamically there is nothing wrong with *murābaḥah*, but there is nothing especially Islamic about it, either. Mark-up or cost-plus pricing is a common business transaction worldwide. Banking primarily based on this type of transactions robs IFIs of distinctively Islamic characteristics. Furthermore, as Islamic banking was designed for greater economic development of Muslims, the current predominance of *murābaḥah* is unhelpful in that regard.

With such idealization of PLS modes and categorical emphasis on partnership-type financing, *muḍārabah* and *mushārakah*, what happened to bring about the present situation? Why have the PLS modes been marginalized and *murābaḥah* and other mark-up type, interest-substitute modes became predominant? Is it that the people running or owning the IFIs are not devoutly committed to Islam, or are they irrational?

IV. Why is the PLS Model being shunned by IFIs?

Businessmen generally are rational. They have reasons not to be deeply enamoured with PLS modes. According to Iqbal and Molyneux (2005: 136):

> There are many reasons why businessmen do not prefer PLS contracts. These include, among others: (i) the need to keep and reveal detailed records; (ii) it is difficult to expand a business financed through *muḍārabah*, because of limited opportunities to re-invest retained earnings and/or raising additional funds; (iii) the entrepreneur cannot become the sole owner of the project except through diminishing *mushārakah*, which may take a long time. Similarly, there are some practical reasons for banks to prefer fixed-return modes, including the fact that due to moral hazard and

> adverse selection problems in all agent-principal contracts such as *muḍārabah*, there is a need for closer monitoring of the project. This requires project monitoring staff and mechanisms, which increase the costs of these contracts. Moreover, on the liabilities side, the structure of deposits of Islamic banks is not sufficiently long term, and therefore they do not want to get involved in long-term projects. Third, PLS contracts require a lot of information about the entrepreneurial abilities of the customer. This may not be easily available.

At the same time, contrary to popular perception of many credulous adherents among Muslims, *murābaḥah* in practice may not be quite as *Sharīʿah*-compliant as generally claimed. It is also heavily criticized or repudiated by many Islamic scholars and even some Islamic financial institutions.

> A number of scholars have recently cast doubts upon the acceptability of one of the most widely used forms of Islamic finance: the type of *Murābaḥah* trade financing practiced in London. These investors and well-known multinationals are seeking lowest-cost working capital loans. Although these multi-billion-dollar contracts have been popular for many years, many doubt the banks truly assume possession, even constructively, of inventory, a key condition of a religiously acceptable *murābaḥah*. Without possession, these arrangements are condemned as nothing more than short-term conventional loans with a predetermined interest rate incorporated in the price at which the borrower repurchases the inventory. These 'synthetic' *murābaḥah* transactions are unacceptable to the devout Muslim, and accordingly there is now a movement away from *murābaḥah* investments of all types. Al-Rajhi Bank, al-Baraka, and the Government of Sudan are among the institutions that have vowed to phase out *murābaḥah* deals. This development creates difficulty: as Islamic banking now operates, *murābaḥah* trade financing is an indispensable tool. (Vogel and Hayes, 1998: 8–9)

Despite such criticisms, cost-plus financing or *murābaḥah* (mostly debt-like instruments) continue to be the mainstay of Islamic banking. In the chapter "The Performance of the Islamic Banks - A Realistic Evaluation", Usmani, a quintessential *Sharīʿah* expert in the field of Islamic banking and finance, laments (Usmani; 2002: 113):

> This [*i.e.* Islamic] philosophy cannot be translated into reality unless the use of *mushārakah* is expanded by the Islamic banks. It

> is true that there are practical problems in using the *mushārakah* as a mode of financing, especially in the present atmosphere where the Islamic banks are working in isolation, and mostly without the support of their respective governments. The fact, however, remains that the Islamic banks should have advanced towards *mushārakah* in gradual phases and should have increased the size of *mushārakah* financing. Unfortunately, *the Islamic banks have overlooked this basic requirement of Islamic banking and there are no visible efforts to progress towards this transaction even in a gradual manner, even on a selective basis.* ... [T]he basic philosophy of Islamic banking seems to be totally neglected. (Emphasis added)

Thus there is a basic contradiction. The PLS/risk-sharing mode has been virtually abandoned in practice, yet "Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance" (Dar and Presley, 2000: 3). There are several explanations identified in the literature for IFIs' entrenched tendency to avoid PLS modes and overwhelmingly use *murābaḥah* and other non-PLS modes. Dar and Presley (2000: 3–4) enumerate several such explanations:

(i) PLS contracts are inherently vulnerable to agency problems as entrepreneurs have disincentives to put in effort and have incentives to report less profit as compared to the self-financing owner-manager. ...
(ii) PLS contracts require well-defined property rights to function efficiently. As in most Muslim countries property rights are not properly defined or protected, PLS contracts are deemed to be less attractive or to fail if used. ...
(iii) Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to *Muḍārabah* or *Mushārakah* in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive. ...
(iv) The restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. ...
(v) Equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely

on some other debt-like modes, especially mark-up to ensure a certain degree of liquidity...

(vi) Unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing...

(vii) Secondary markets for trading in Islamic financial instruments, particularly *Muḍārabah* and *Mushārakah*, are non-existent. Consequently, they have so far failed to effectively mobilise financial resources.

Each of these explanations has merit. Indeed, the starting point of any such critical evaluation of the gap between rhetoric and reality might be that the Islamic finance discourse simply has exaggerated the "usefulness" and relevance of PLS modes (Dar and Presley, 2000: 15), which may also have stemmed from a fundamental problem with the notion that *ribā* and interest are equivalent and that since *ribā* is prohibited in Islam, so is interest (Farooq, 2007).

V. Why is Partnership the Least Common form of Business Organization?

Business organizations usually take three broad forms: sole proprietorship, partnership and corporation. Islamic finance, at the level of rhetoric, embraces various forms of partnership or equity-sharing. Three such forms that can take various sharing modes are:

(i) Partnership: least common type of business organization;

(ii) Equity-financing: corporate structure; few publicly traded corporations; private corporations are greater risk

(iii) Venture capital partnership: entrepreneurial finance; risky; small portion

None of these forms is predominant or common in the portfolio of IFIs. It has already been explained why IFIs might not find PLS modes attractive and practical. However, the issue can be approached from another angle. Which of these three forms of business organization – sole proprietorship, partnership and corporation – is the least common? For example, in the context of the United States (and it is not much different in many developed countries), the least common is partnership, as depicted in Table 1.

Table 1: Distribution of Businesses by Legal Types in USA

	Number	Revenue	Profits
Sole Proprietorship	72%	5%	16%
Partnership	8%	8%	15%
Corporation	20%	87%	69%

Source: Statistical Abstracts of the United States, 2004–2005

As a legal form of business organization, partnership is the least popular, for well-established reasons. Some of these are: split/divided authority; hard to find suitable/compatible partners; conflict between partners, etc. An *Inc.* magazine poll in USA on "Are partners bad for business?" is revealing (Caggiano, 1992), which is depicted in table 2.

Table 2: Responses to PLS Financing Related Issues

	Yes	No
Is partnership a bad way to run a business?	59%	39%
Why is partnership bad?	**Response Rate**	
Personal conflicts outweigh the benefits	60%	
Partners never live up to one another's expectations	59%	
Companies function better with one clear leader	53%	

Source: Caggiano (1992)

The survey also indicated some positive aspects that the participants appreciated. However, of those who characterized partnerships as good, the majority (60%) said they were or are involved in "equal partnerships". This notion of "equal partnership" might explain why PLS models appear unattractive both to businesses and IFIs simply because most associations involving IFIs and their clients are not interested in such equal partnerships.

Another *Inc.* magazine study of 500 partnership businesses concluded that partners in each of those businesses knew one another long before working together. An illuminating article titled "Partners are from Mars" explains through partners' experience why prior closer acquaintance is important (Sherman, 2000). While Sherman's work sheds light on individual partners, some essential issues of compatibility and conflict are more common to partnership than to other forms of business organization.

In a competitive setting, where IFIs have to offer their services and businesses have to utilize IFIs' services, such partnership or equity-sharing models simply are not compellingly attractive to either side. These problems are not limited to just partnerships (general or limited), but also to all equity-sharing modes, including corporations and venture capitalists.

Such considerations are further complicated by some restrictive elements of classical parameters of Islamic contracts and business structures, which are not necessarily derived from either the Qur'ān or Sunnah. They are primarily interpretative, speculative derivations by jurists.

Here are some examples: "Imam Malik and Hanbali jurists are of the view that 'the liquidity of capital is not a condition for the validity of *mushārakah*" (Usmani, 2002: 8). Equity-sharing modes can run into problems often, when partners bring illiquid capital to the business: "Imam Abu Hanifah and Imam Ahmad are of the view that no contribution in kind is acceptable in a *mushārakah*" (Usmani, 2002: 9).

On the other hand, some classical schools restrict in-kind contribution to *Mushārakah*. Thus the anomalies among various schools are notable, which is explained by the fact that there is nothing direct and specific in the Qur'ān and Sunnah, from which to derive the above rules. Why not let businesses work out these matters? Perhaps Islamic legal thinking has tended at times toward over-definition or excessive prescriptiveness: expert guidance that the jurists and scholars could have offered was turned into matters of law.

According to Usmani, "the rules of financing in both *mushārakah* and *muḍārabah* are similar" (Usmani, 2002: 12). Let us take a further look at some of the basic principles of *mushārakah* and *muḍārabah*.

(i) "Financing through *mushārakah* and *muḍārabah* does never mean the advancing of money. It means participation in the business and in the case of *mushārakah*, sharing in the assets of the business to the extent of the ratio of financing" (Usmani, 2002: 17).

Clients of IFIs cannot be expected to like this limitation. It is just that simple. One can contend that client businesses are supposed to act according to Islam and, regardless of any other factor, simply seek out PLS modes. After all, *ribā* is prohibited and so is interest – as the argument goes. Unfortunately, the problem may lie right there. Although *ribā is* categorically prohibited, interest on loans for mutual benefits and mutually agreed, without any exploitative aspects, may not be prohibited (Farooq,

2007). Thus, devising of business modes and practices for compatibility with the presumed scope of prohibition may be Islamically untenable.

(ii) "An investor/financier must share the loss incurred by the business to the extent of his financing" (Usmani, 2002: 17).

In theory it sounds good. However, as businesses IFIs do not care to enter into undertakings that would expose them to indeterminate loss. Rational businesses generally try to maximize profit (subject to other parameters) and thus also try to minimize loss and risk. IFIs cannot artificially alter the commonsense human response. While businesses may not like IFIs to get closely involved in partnerships, IFIs themselves deem as unattractive their role as passive equity-investor.

> Since the use of risk-sharing modes, considered to be the hallmark of Islamic banking, is rather limited, clients do not notice any significant operational departure from the previous practices based on fixed rate financing. (Iqbal and Molyneux, 2005: 126)

Thus, while IFIs keep their transactions presumably interest-free by avoiding debt instruments, in practice they mimic conventional financial institutions and confine themselves to contracts that are debt-like, such as mark-up type transactions (*murābaḥah, ijārah, salam*, *etc.*).

(iii) "The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment. However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment" (Usmani, 2002: 17).

This is obviously related to issues of agency. Having banks/lenders as active partners is not liked by the businesses. Without being active management partners, which is not possible for financial institutions, IFIs incur both agency problems, asymmetric information and moral hazard. Client businesses may hold back accurate information about profit and loss: profit could be understated; and loss could be overstated or understated depending on particular advantages potentially sought by the partner businesses.

As for moral hazard,

> [I]t arises when a contract or financial arrangement creates incentives for parties to behave against the interest of others. It is generally believed that moral hazard problems are much more serious in profit-sharing contracts than in interest-based contracts, which is one of the reasons for their lack of popularity in Islamic banks. One problem, for example, is the incentive the borrower may have in concealing the true level of profits, or absorbing some of the profits through unauthorized perquisites. (Iqbal and Molyneux, 2005: 143–144)

However, Iqbal and Molyneux (2005: 144) do concede that the problem of moral hazard in this context may have been overstated:

> While there may be a grain of truth in this argument, we believe the matter has been exaggerated. For one thing, these problems are not unique to profit-sharing contracts; they are similar to those that arise in any equity contract in conventional systems. For another, the problem of moral hazard also exists in interest-based contracts.

In the economics literature, there are contrasting positions about the relative efficiency of sharing arrangements. A widely held perception among economists is that sharing arrangements are less efficient compared to first-choice solutions. Stiglitz and Weiss (1981), for example, write:

> In general, revenue sharing arrangements such as equity financing, or sharecropping are inefficient. Under those schemes the managers of a firm or the tenant will equate their marginal disutility of effort with their share of their marginal product rather than with their total marginal product. Therefore, too little effort will be forthcoming from agents.

The same problem arises in corporate management (Iqbal and Molyneux, 2005: 147). Iqbal and Molyneux then present counter-arguments from the economics literature. However, if the trendline for PLS contracts in IFIs' portfolio is any indication, there is no appreciable change in favour of PLS to confirm that the problem is overstated.

Based on primary survey data, Khalil *et al.* (2002) investigated three main questions:

(i) What are the aims of the monitoring system in *muḍārabah* contracts?
(ii) What are the main areas of activity to be monitored?
(iii) What are the main devices which agents use in monitoring the *muḍārabah* contract?

The authors clarify:

> In general, a number of distinctive features can be attributed to the *Muḍārabah* contract to reflect its nature and the inherent magnitude of agency-contractual problems. We identify three main features; namely, idiosyncratic uncertainty (risk), extreme linearity and discretionary power. ... [I]diosyncratic uncertainty, particularly for the bank, is embodied in profit-sharing contracts. This uncertainty has many sources: the bank's return is assumed to depend solely on the reported future cash flows resulting from operating profitability, which in turn depends entirely on the corporate investment decisions that are made by the agent. Moreover, the agent is not fully supervised, and has a measure of independence. Given that the agent's level of effort may be regarded as unobservable, it cannot be contracted. Moreover, the uncertainty is exacerbated by lack of security over assets. ... Accordingly, uncertainty will be severe and the bank bears very significant risks, particularly in the case of occurrence of losses. This may give rise to high incidence of adverse selection and moral hazard problems, which are facilitated by the ability of entrepreneur, in such contracts to hide information regarding his abilities and background before contracting and to conceal actions taken after the contract is put in place. In addition, the outcome may not be reported truthfully by the agent...
>
> Monitoring costs may be incurred in all stages of the contract to ensure compliance with the terms of the contract, and to convey verifiable and informative signals about the entrepreneur's behavior...
>
> *Muḍārabah* contract ... provides the entrepreneur with full discretion over assets, similar to that assigned to sole owner-manager projects, without bearing the risk of financial losses. By contrast with equity, there are no automatic rights to make appointments to the board of directors using associated voting power, which would give the financier some scope of intrusive oversight of operating activity. (Khalil *et al.,* 2002: 59–60)

It is worth emphasizing that the entrepreneur under a *muḍārabah* has full discretion over the assets and operation, without bearing the risk of financial loss. Usmani (n.d.) explains:

(i) in *muḍārabah*, investment is the sole responsibility of the *rabb al-māl* [*i.e.* the financing partner]

(ii) in the *muḍārabah*, the *rabb al-māl* has no right to participate in the management which is carried out by the *muḍārib* [*i.e.* entrepreneur] only.

(iii) in *muḍārabah* the loss, if any, is suffered by the *rabb al-māl* only, because the *muḍārib* does not invest anything. His loss is restricted to the fact that his labour has gone in vain and his work has not brought any fruit to him.

These distinctive characteristics of *muḍārabah*, as specified by classical Islamic jurisprudence, illustrate the underlying reasons why such arrangements are not compellingly attractive to rational financiers on a PLS basis. Thus, in the context of bank participation in a project, all the financing would come from the bank with the entrepreneur making no financial contribution to it. The risk of financial loss would be borne by the bank – the financing partner – while the entrepreneur's loss would be limited to his labour. Could a rational investor or financier find such an arrangement attractive?

While there is a compelling case for the impracticality of classical *muḍārabah*, what about *mushārakah*? Here are some of the salient features of *mushārakah*, as articulated by Usmani (n.d.).

(i) The investment in *mushārakah* comes from all the partners.

(ii) In *mushārakah*, all the partners can participate in the management of the business and can work for it.

(iii) In *mushārakah* all the partners share the loss to the extent of the ratio of their investment.

(iv) The liability of the partners in *mushārakah* is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne pro rata by all the partners. However, if all the partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition.

(v) In *mushārakah*, as soon as the partners mix their capital in a joint pool, all the assets of the *mushārakah* become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can benefit from the appreciation in the value of the assets, even if profit has not accrued through sales.

The conditions of *mushārakah* are more practical for enlisting partner participation or equity-financing. So, why is *mushārakah* not more common

in IFIs' portfolio? The very nature of banks may help explain this fact. Banks are generally specialized for financial intermediation, not for participation in businesses as partners or on the basis of equity-financing. IFIs are like merchant banks, not banks in the conventional sense. Historically, "merchant banks, now so called, are in fact the original 'banks'. These were invented in the Middle Ages by Italian grain merchants" (Wikipedia, 'Merchant Banking'). There were good economic and financial reasons for merchant banking to become widespread.

> Merchant banks first arose in the Italian states in the Middle Ages, when Italian merchant houses – generally small, family-owned import-export and commodity trading businesses – began to use their excess capital to finance foreign trade in return for a share of the profits. This trade generally consisted of lengthy sea voyages. Thus, the investments were very high risk: war, bad weather, and piracy were constant threats, and by their nature the voyages were long-term and illiquid. (Craig, 2001)

In the banking industry, merchant bank is another name for investment bank. In the wake of the 1929 crash in the US, commercial banking was gradually but completely separated from investment banking. And parallel to commercial banks a private equity market, to be served by investment banking, developed into a special and significant niche.

> Although not defined in U.S. federal banking and securities laws, the term merchant banking is generally understood to mean *negotiated private equity investment by financial institutions in the unregistered securities of either privately or publicly held companies.* Both investment banks and commercial banks engage in merchant banking, and the type of security in which they most commonly invest is common stock. They also invest in securities with an equity participation feature; these may be convertible preferred stock or subordinated debt with conversion privileges or warrants. Other investment bank services – raising capital from outside sources, advising on mergers and acquisitions, and providing bridge loans while bond financing is being raised in a leveraged buyout (LBO) – are also typically offered by financial institutions engaged in merchant banking. (Craig, 2001; emphasis added).

Compared to merchant banking, investment banking became further defined:

> Investment banks assist public and private corporations in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions. They also act as intermediaries in trading for clients. (Wikipedia, 'Investment')

Quite common in Europe is another banking practice – universal banking. This covers the entire range of financial services, including the traditional products offered by commercial banks as well as holding claims on firms (including equity and debt), and participating "directly in the corporate governance of firms that rely on the banks for funding or as insurance underwriters" (Calomiris, 1995). Developed countries, especially in Europe, are experiencing more universal banking.

> Continental European banks are engaged in deposit trading, real estate and other forms of lending, foreign exchange trading, as well as underwriting, securities trading, and portfolio management. In the Anglo-Saxon countries and in Japan, by contrast, commercial and investment banking tend to be separated. In recent years, though, most of these countries have lowered the barriers between commercial and investment banking... (Rich and Walter, 1993: 289)

But even in countries where universal banking is common, such as in Germany, equity-financing generally averages one-quarter of their portfolio as of 1991 (Rich and Walter, 1993: 297). Notably, it is neither mandated by the government, nor is any particular pattern observable. Indeed, many of these banks choose to specialize, albeit operating as universal banks.

The issue of universal banking is relevant since Islamic banking is attempting to function as a full service financial institution whereas, based on their learning curves, the financial institutions have evolved to be specialized while keeping available the full range of choices. Some more recent work provides empirical support for the view that equity participation of banks in business financing can have positive impact.

> Equity participation by banks can help overcome a well-documented agency problem, namely the ability of banks to extract rents from their captive borrowers. Reducing this problem creates value for firms, their banks, and the economy as a whole by improving the firms' investment incentives. (Mahrt-Smith, 2006)

The same author also points out that, while equity participation by banks can be a negative incentive to their profit extraction, this can be overcome: "The negative effect of bank profit extraction can be significantly reduced when the bank holds a mix of debt and equity as opposed to pure debt".

No empirical work is available to support the position that banks' equity participation in businesses seeking finance has a positive impact, when the participation is exclusively equity-based (*i.e.*, without combining with debt-financing). This is incompatible with Islamic banking, as IFIs want to serve as financial intermediaries and as merchant-cum-investment banks, with the parameters that their services are supposed to be *primarily* (or, even exclusively) based on PLS mode and there is no room for conventional debt-financing.

Under such conditions can *muḍārabah* or PLS contracts be modified? The answer is yes, although it would need to be significantly delinked from classical Islamic jurisprudence, which is the foundation of Islamic finance. There is a palpable need for new 'financial engineering'.

> Financial markets are becoming more and more sophisticated, and competitive. In order to exploit the fast changing market environment and face increasing competition, financial engineering and innovation is imperative.
>
> Until now, the Islamic financial tools have essentially been limited to classical instruments developed centuries ago and their variants. Those instruments were developed to meet the needs of those societies. While they may serve as useful guidelines for Islamic contracts, there is no reason to be restricted only to them. (Iqbal *et al.*, 1998: 65)

The first issue may well be with the way the prohibition of *ribā* has been overextended in classical Islamic jurisprudence and then, through the *ribā*–interest equation, has remained an overstretched carryover to modern times due to strict legalistic approach. The evidence of IFI behaviour is quite clear that, even though they aim to be interest-free and thus avoid monetary debt contracts, in reality they have landed on *ḥiyal* (ruse; legal stratagems) by following the prohibition in form, while circumventing it in substance.

Indeed, the fascination with PLS-only as the ideal Islamic mode is a carryover from classical Islamic jurisprudence, which the so-called *homo Islamicus* is finding insurmountably difficult to implement. Naqvi, a notable authority in the field, has made some revealing comments:

> The most widely held view is that Islamic banks should deemphasize use of the fixed rate of return instruments, and that, reversing present trends, they should be run exclusively on the basis of the profit and loss sharing (PLS) principle to become truly Islamic. It is argued that any attempt to dilute the importance of the PLS principle in Islamic banking theory or practice by the use of even the *Sharīʿah*-compatible fixed rate of return instruments will make Islamic banking less efficient and less equitable because this is the one principle most recommended by the *Sharīʿah* (*i.e.,* the Islamic Law) (*e.g.*, Siddiqui, 1983a; Chapra, 1985; and Usmani, 1998). From this point of view, it does not matter if the PLS instruments have lost out in the process of 'natural selection', practically vanishing from the Islamic bank's portfolios. The almost 'universal' recommendation still is that the PLS principle be observed faithfully, even exclusively, because it is hoped that — presumably by some variant of Say's Law — an ample supply of such instruments will create their own demand. But this argument comes dangerously close to circular reasoning: it makes the desired efficiency and equity outcomes of Islamic banking contingent on the adoption of the PLS principle, which is prejudged as the only one which is Islamically just! The possibility that the PLS principle, if implemented universally and without any safeguards, may itself lead to inefficiency and inequity is totally alien to this antiseptically 'consequence-insensitive' procedural way of thinking. (Naqvi, 2000: 42)

VI. Conclusion

IFIs proclaim that the conventional financing based on interest is unjust since there is no fair sharing of profit-loss and risk. However, the IFIs themselves do not utilize PLS modes substantively in their portfolios. A bulk of the problem stems from the parameters for the PLS modes in classical Islamic laws. The problems facing the IFIs can be addressed with innovations, but the solutions then become less-anchored in the traditional Islamic legal discourse. Many suggested innovations, as well as many current practices, make the IFIs resemble conventional finance. Islamic discourse ignores the underlying reality that partnership is the least common business organization due to certain inherent problems associated with it. Those problems are real and human behaviour in such business organizational contexts, in avoiding the PLS and risk-sharing modes, is being rational.

The preoccupation with PLS modes stems from the presumed prohibition of interest and dislike of debt instruments in business. Notwithstanding that this prohibition may suffer problems of interpretation and overly expanded

scope, nevertheless, the IFIs make up ruses (*ḥiyal*) to manufacture products and services that are only legally Islamic or *Sharīʿah*-compliant. But there isn't much difference in substance between IFIs and conventional financial institutions. This being the case it is no wonder that conventional financial institutions are aggressively grabbing their share of this niche market as they can easily adapt the form of their operations. Yet in reality they have less risk in the Islamic market, while earning profit that is comparable to or better than that which they earn in their conventional market.

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