

**Partnership, Equity-financing and Islamic finance:
Whither Profit-Loss-Sharing?**

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August 2006
[**Draft in progress**: Feedback welcome]

Introduction

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 IBF movement is the Islamic prohibition of *Riba*, which the orthodoxy equates with interest in general. To completely avoid interest as its central allocation tool, IBF has developed an impressive array of modes of transactions that is claimed to be primarily based on profit-loss-sharing (PLS) modes. PLS modes are to avoid debt-financing and use partnership and equity-financing, similar to venture capitalism. Paradoxically, while the pertinent literature continues to emphasize PLS modes as the main modes, the practice of Islamic financial institutions (IFIs) is such that they have deliberately and systematically avoided PLS modes. Such modes are often presented as various forms of partnership financing. This paper argues that there is a serious problem with the partnership framework, in which equity-financing is considered. The problem lies with the very nature of partnership as a legal form of business organization. It is further argued that without modifying various contractual aspects of the equity-financing, it is only economically rational for IFIs to predominantly use debt-like instruments, while claiming its Islamicity on the basis of almost non-existent PLS modes.

Idealization of PLS Mode in Islamic Finance

One of the key precepts of Islamic finance is that under conventional systems based on interest, neither profit and loss nor risk is shared by the contracting parties.

“[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.”¹

"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 *Mudaraba* and *Musharaka*, is desirable in an Islamic context wherein reward-sharing is related to risk-sharing between transacting parties."²

"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

¹ Muhammad Taqi Usmani. *An Introduction to Islamic Finance* [The Hague: Kluwer Law International, 2002], p. 113.

² Humayun Dar and John Presley. "[Lack of Profit Loss Sharing in Islamic Banking: Management and Control Imbalances](#)," *International Journal of Islamic Financial Services*, Vol. 2 No.2, July-Sept. 2000, pp. 3-18, on p. 3.

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."³

To remedy the claimed harms of interest-based arrangements, the orthodox Islamic finance claims that financing should be based on fair sharing of profit/loss and risk. The financing/business forms that are claimed as the model Islamic forms are *Mudaraba* and *Musharaka*.

The movement for Islamic banks and financial institutions originally began with identifying *Mudaraba* [investment partnership involving (a) active or managing and (b) silent or capital-contributing partners] and *Musharaka* [partnership in general] as the primary modes of operation, arguing that Islam believes in profit-loss-sharing (PLS and thus, risk-sharing). "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)."⁴ According to Muhammad Taqi Usmani, one of the leading Shariah experts, who also serves on the boards of almost a dozen different Islamic banks or banks with Islamic operations, "The real and ideal instruments of financing in Shariah are *musharaka* and *mudaraba*."⁵ The author further adds about *musharaka*:

"*Musharaka* is a specific form of *shirkah*, which "means 'sharing' of various kinds, including *shirkat-ul-milk* ("joint ownership of two or more persons in a particular property"), *shirkat-ul-aqd* ("a partnership in business effected by a mutual contract"). *Musharaka* "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 *shirkatul-amwal*, where two or more persons invest some of their capital in a joint commercial venture. However, sometimes it includes *shirkat-ul-a'mal* also where partnership takes place in the business of services."⁶

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

Even though PLS modes are idealized in Islamic finance, the reality is that, as it currently stands, it is seriously marginalized in IFIs.

"Almost all theoretical models of Islamic banking are either based on *Mudaraba* or *Musharaka* 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.

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 *Mudaraba Companies* ... in Pakistan, which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a *Mudaraba* or *Musharaka* basis. According to the International Association of Islamic Banks, PLS

³ Munawar Iqbal and Philip Molyneux. *Thirty Years of Islamic Banking: History, Performance and Prospects* [Palgrave, 2005], p. 28.

⁴ *ibid.*, p. 28.

⁵ Usmani, *op. cit.*, p. xv.

⁶ Usmani, pp. 5-6.

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."⁷

It is clearly established that most of the Islamic banks have now given up or marginalized those two (risk-sharing/PLS) modes, and have turned to the predominant mode of *Murabaha*, a mode that allows them to ensure that they avoid risk almost altogether in their transactions and earn relatively high return. These banks have found *Mudaraba* and *Musharaka* to be inoperable in the modern context.⁸ Vogel and Hays reveals: "While the distinction from a mere loan is compelling in theory, in practice Islamic banks often employ various stratagems to reduce their risks in murabaha almost to zero, particularly in international trade."⁹ Thus, quietly they have disengaged from the PLS/risk-sharing modes and embraced *Murabaha*, which is described by many as "*murabaha* syndrome: the strong and consistent tendency of Islamic banks and financial institutions to utilize debt-like instruments" particularly in external financing.¹⁰

"*Murabaha*, 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 murabaha 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.'"¹¹

Interestingly, Siddiqi, one of the leading proponents and experts of Islamic economics and banking, asserted during his earlier writings in the 1980s: "For all practical purposes this [the mark-up system or Murabaha] will be as good for the bank as lending on a fixed rate of interest."¹² After providing 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 Musharaka which ensures that the above inequalities do not occur. ... Musharaka 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."¹³ The same viewpoint was clearly echoed in The Text of the Historic Judgment on Interest by the Supreme Court of Pakistan: "The Council has in fact suggested that the true alternative to the interest is profit and loss sharing (PLS) based on Musharakah and Mudaraba.

Siddiqi 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

⁷ Dar and Presley, *op. cit.*, p. 3.

⁸ Abdullah Saeed. *Islamic Banking and Interest: A Study of the Prohibition of Riba and its Contemporary Interpretation* [New York: E. J. Brill, 1996], see chapter "Murabaha Financing Mechanism," pp. 76-95; Rajesh Aggarwal and Tarik Yousef. "Islamic Banks and Investment Financing," *Journal of Money, Credit and Banking*, Vol. 32, No. 1, February 2002, pp. 93-120, on p. 106; Frank Vogel and Samuel Hayes, III. *Islamic Law and Finance: Religion, Risk and Return* [The Hague: Kluwer Law International, 1998], p. 7.

⁹ Vogel and Hayes, p. 141.

¹⁰ Tarik Yousef. "The Murabaha Syndrome in Islamic Finance: Laws, Institutions and Politics," in Clement Henry and Rodney Wilson (eds.). *The Politics of Islamic Finance* [Edinburgh University Press, 2004], pp. 63-80, p. 65.

¹¹ Saeed, p. 87.

¹² Mohammad Nejatullah SIDDIQI. *Issues in Islamic Banking* [Leicester: The Islamic Foundation, UK, 1983], p. 139.

¹³ Sufyan Ismail. "Why Islam has prohibited Interest and Islamic alternatives for financing," Chief Executive, 1st Ethical. <http://www.1stethical.com/TheproblemswithInterest.pdf>, pp. 16, 21.

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 *murabaha*, *bay' 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."¹⁴

Why PLS model is being shunned by IFIs?

The businessmen are not irrational. They have reasons not to be deeply enamored with PLS modes. According to Iqbal and Molyneux,

"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 *mudaraba*, 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 *musharakah*, 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 *mudaraba*, 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."¹⁵

It is noteworthy that, contrary to popular perception of the believing Muslims, *Murabaha*, as practiced, may not be quite Shariah-compliant as generally claimed and it is 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 *Murabaha* 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 *murabaha*. 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' *murabaha* transactions are unacceptable to the devout Muslim, and accordingly there is now a movement away from *murabaha* investments of all types. Al-Rajhi Bank, al-Baraka, and the Government of Sudan are among the institutions that have vowed to phase out *murabaha* deals. This development creates difficulty: as Islamic banking now operates, *murabaha* trade financing is an indispensable tool.¹⁶

However, things have fundamentally changed relative to the originally postulated principles of Islamic banking, and despite the criticisms or lack of the desired Shariah-compliance, cost-plus financing or *Murabaha* (mostly debt-like instruments) continue to be the mainstay of Islamic

¹⁴ Siddiqi, 1983, p. 52.

¹⁵ Iqbal and Molyneux, p. 126.

¹⁶ Vogel and Hayes, pp. 8-9.

banking. In the chapter "The Performance of the Islamic Banks - A Realistic Evaluation" Usmani, a quintessential Shariah expert in the field of Islamic banking and finance, makes a stunning revelation as he laments:

"This [i.e., Islamic] philosophy cannot be translated into reality unless the use of musharakah is expanded by the Islamic banks. It is true that there are practical problems in using the musharakah 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 musharakah in gradual phases and should have increased the size of musharakah 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."¹⁷

Yet, even though PLS/Risk-sharing mode has been virtually abandoned, quite deceptively, "Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance."¹⁸ There are several explanations identified in the literature for IFIs' entrenched tendency to avoid PLS modes and overwhelmingly use *murabaha* and other non-PLS modes. Dar and Presley [2000] enumerate several such explanations:

- "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. ...
- 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. ...
- Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive. ...
- 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. ...
- 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. ...
- 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. ...
- secondary markets for trading in Islamic financial instruments, particularly Mudaraba and Musharaka, are non-existent. Consequently, they have so far failed to effectively mobilise financial resources."¹⁹

Each of these explanations has some merits. 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,²⁰ which may also have

¹⁷ Usmani, p. 113; emphasis is mine.

¹⁸ Dar and Presley, p. 3.

¹⁹ *ibid.*, pp. 3-4.

²⁰ Dar and Presley, *ibid.*, p. 15.

stemmed from a fundamental problem with the notion that *riba* and interest are equivalent (and since *riba* is prohibited in Islam, so is interest).

Why partnership is 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 that can take various sharing modes are:

- Partnership: least common type of business organization;
- Equity-financing: corporate structure; few publicly traded corporations; private corporations are greater risk
- 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 very attractive and practical. However, there is another angle from which the issue can be approached. Which of the three forms of business organization - sole proprietorship, partnership and corporation - is the least common? For example, in the context of USA (and it is not much different in many developed countries), the least common is partnership.

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 reasons that are well established. 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.²¹

Is partnership a bad way to run a business?

Yes 59% No 39%

Why is partnership bad?

Personal conflicts outweigh the benefits 60%

Partners never live up to one another's

expectations 59%

²¹ Christopher Caggiano. "Are Partners Bad for Business? FaxPoll results on questions about partnership," *Inc. Magazine*, Feb 1992. <http://www.inc.com/magazine/19920201/3913.html>

Companies function better with one clear leader

53%

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 matter of "equal partnership" might explain why PLS models do not appear attractive either by businesses or IFIs for the simple reason that most relationships involving IFIs and their clients are not interested in such equal partnerships.

Another Inc. Magazine study of 500 partnership businesses found that partners in each of those businesses knew one another long before working together. In a competitive setting, where IFIs have to offer their services and businesses have to utilize their 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.

These problems are further complicated by some of the restrictive elements of classical parameters of Islamic contracts and business structures, which are not necessarily derived from the Qur'an or Sunnah directly, but are primarily derivations by jurists based on human interpretations.

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 *musharaka*'."²²

Equity-sharing modes often can run into problem, when partners bring capital to the business that is not liquid.

"Imam Abu Hanifah and Imam Ahmad are of the view that no contribution in kind is acceptable in a *musharaka*."²³

On the other hand, some of the classical schools restrict in-kind contribution to *Musharaka*. There isn't really anything direct and specific in the Qur'an and Sunnah to derive the rules like the above. Why not leave these matters to the businesses to work out? The problem is that Islamic laws gradually tended toward overstretched legalism. What the jurists and scholars could have offered as expert guidance was turned into matters of law.

According to Mufti Muhammad Taqi Usmani, "the rules of financing in both *musharakah* and *mudaraba* are similar"²⁴ Let us take a further look at some of the basic principles of *musharaka* and *mudaraba*.

(1) Financing through *Musharaka* and *mudaraba* does never mean the advancing of money. It means participation in the business and in the case of *musharakah*, sharing in the assets of the business to the extent of the ratio of financing.²⁵

²² Usmani, *op. cit.*, p. 8.

²³ Usmani, p. 9.

²⁴ Usmani, p. 12.

²⁵ Usmani, p. 17.

This limitation is not liked by the clients of IFIs. It is just as simple as that. One can argue that aren't the client businesses supposed to act according to Islam and, regardless of any other factor, simply seek out PLS modes? After all, *riba* is prohibited and so is interest. Unfortunately, the problem may lie right there. Although *Riba* is categorically prohibited, interest in loans for mutual benefits and mutually agreed, without any exploitative aspects, may not be prohibited. Thus, trying to devise business modes and practices to make it compatible with the presumed scope of prohibition that simply may be Islamically untenable.

(2) An investor/financier must share the loss incurred by the business to the extent of his financing.²⁶

In theory it sounds good. However, IFIs, as businesses, do not like to enter into undertakings that would expose them to share of losses. Rational businesses generally try to maximize profit (subject to other parameters) and thus also try to minimize loss and risk. IFIs can't artificially alter the common sense human behavior. Thus, while one can argue that businesses themselves are not greatly interested in IFIs getting closely involved in businesses as partners, it is also true that IFIs also have found their involvement as partners or passive equity-investor unattractive.

"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."²⁷

Thus, while IFIs stand on the premise of being interest-free in their transactions, avoiding debt instruments, in their practice they mimic the conventional financial institutions and broadly limit themselves to contracts that are debt-like, such as mark-up type transactions (*murabaha*, *ijara*, *salam*, etc.)

(3) 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.²⁸

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

[it] 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 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."²⁹

Iqbal and Molyneux argue that the problem of moral hazard in this context may have been overstated.

²⁶ Usmani, p. 17.

²⁷ Iqbal and Molyneux, *op. cit.*, p. 126.

²⁸ Usmani, p. 17.

²⁹ Iqbal and Molyneux, *op. cit.*, pp. 143-144.

"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."³⁰

In economic literature, there are contending 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."³¹

Iqbal and Molyneux then present counter arguments from the economic literature. However, if the trendline for PLS contracts in IFIs' portfolio is any indication, there is no appreciable change in favor of PLS to suggest that the problem is overstated.

Based on primary survey data, an empirical study on "Evidence on agency-contractual problems in *mudarabah* financing operation by Islamic banks," the authors investigated three main questions:

1. What are the aims of the monitoring system in *mudaraba* contracts?
2. What are the main areas of activity to be monitored?
3. What are the main devices which agents use in monitoring the *mudaraba* contract?

The authors [*Khalil et al.*]³² clarify:

"In general, a number of distinctive features can be attributed to the *mudaraba* 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

³⁰ Iqbal and Molyneux, p. 144.

³¹ Iqbal and Molyneux, p. 147.

³² Abdel-Fattah A.A. Khalil, Colin Rickwood, and Victor Murinde. "Evidence on agency-contractual problems in *mudaraba* financing operations by Islamic banks," in Munawar Iqbal and David T. Llewellyn (eds.). *Islamic Banking and Finance: New Perspective on Profit-Sharing and Risk* [UK: Edward Elgar, 2002]

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. ...

Mudaraba 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."³³

The point that the entrepreneur has full discretion over the assets and operation, but doesn't bear the risk of financial losses is worth noting. Usmani, a leading shariah expert, enunciates:

1. in *mudaraba*, investment is the sole responsibility of the *rabb-ul-mal* [i.e. the financing partner]
2. in the *mudaraba*, the *rabb-ul-mal* has no right to participate in the management which is carried out by the *mudarib* [i.e. entrepreneur] only.
3. in *mudaraba* the loss, if any, is suffered by the *rabb-ul-mal* only, because the *mudarib* does not invest anything. His loss is restricted to the fact that his labor has gone in vain and his work has not brought any fruit to him.³⁴

The distinctive characteristics of *mudaraba*, as specified by classical Islamic jurisprudence, are illustrative of the underlying problems as to why such arrangements are not so compellingly attractive to rational financiers on a PLS basis. In the context of bank participation, this would mean that financing would be from the bank only and the entrepreneur will not have any financial contribution to the project. It also means that financial risk of loss would be borne exclusively by the bank, the financing partner, while the entrepreneur's loss would be limited to his labor. Would a rationale investor or financier find such an arrangement attractive?

While the unattractiveness of classical *mudaraba* is compelling, what about *musharaka*? Here are some of the salient features of *musharaka*, as enunciated by Usmani.

1. The investment in musharakah comes from all the partners
2. In musharaka, all the partners can participate in the management of the business and can work for it.
3. In musharaka all the partners share the loss to the extent of the ratio of their investment.
4. The liability of the partners in musharaka is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in 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.
5. In musharaka, as soon as the partners mix up their capital in a joint pool, all the assets of the musharaka become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can

³³ Khalil, *et. al.*, pp. 59-60.

³⁴ Muhammad Taqi Usmani. Musharakah & Mudarabah [undated, available [online](#)]

benefit from the appreciation in the value of the assets, even if profit has not accrued through sales.³⁵

The conditions of *musharakah* are more practical for enlisting partner participation or equity-financing. So, why is not *musharaka* as common and prevalent in IFIs' portfolio? This may be explained by the very nature of banks. 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."³⁶

"Merchant banks first arose in the Italian states in the Middle Ages,¹ 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."³⁷

In the banking arena, merchant bank is another name for investment banks. Gradually, commercial banking, especially in the USA in the aftermath of 1929 crash, was completely separated from investment banking, and parallel to commercial banks, 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."³⁸

Gradually, even the investment banking, in comparison with merchant 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."³⁹

In Europe, another variation in banking practices is more common: universal banking. Such banking covers the entire range of financial services, the traditional products offered by commercial banks as well as holding claims on firms (including equity and debt), and participating

³⁵ Usmani, Musharakah & Mudarabah, online.

³⁶ http://en.wikipedia.org/wiki/Merchant_bank

³⁷ Valentine V. Craig. "Merchant Banking: Past and Present," *FDIC Banking Review*, Vol. 14, No. 1, September 2001 [available [online](#)]

³⁸ Craig, 2001; online

³⁹ http://en.wikipedia.org/wiki/Investment_bank

"directly in the corporate governance of firms that rely on the banks for funding or as insurance underwriters."⁴⁰

"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 ..."⁴¹

However, even in many of those countries where universal banking is common, for example in Germany, equity-financing is generally average one-quarter of their portfolio.⁴² What is important is that it is neither mandated by the government nor any particular pattern is observable. Indeed, many of these banks, even operating as universal banks, choose to specialize.

The reason the issue of universal banking is relevant because Islamic banking is trying to function as a full service financial institution, where the general history of financial institutions, based on their learning curves, have taken the path of specialization and even that with the full range of choice available to them. On the other hand, Islamic banking wants to serve as a financial intermediary and as a merchant-cum-investment bank, with the parameter that its services are supposed to be primarily based on PLS mode.

A question can be raised as to whether such conditions of *mudaraba* or PLS contracts can be modified? The answer is yes, but the problem is that then it would be significantly delinked from the classical Islamic jurisprudence, which is the foundation of Islamic finance to begin with. There is a recognized 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."⁴³

However, the real problem may lie with the way the prohibition of *riba* has been a straightforward and then overstretched carryover to modern times. The other problem may be approaching it in a completely legalistic manner. The evidence of IFIs behavior is quite clear that just because it is based on the foundation to be interest-free and thus avoid monetary debt contracts, in reality the IFIs have ended up in *hiyal* (ruse; legal stratagems) to follow the prohibition in forum, but circumvent it in substance.

Indeed, the fascination with PLS-only as the ideal Islamic mode is a hangover from the classical Islamic jurisprudence, which is the so-called *homo Islamicus* is finding insurmountably difficult to

⁴⁰ Charles W. Calomiris. "[Universal banking and the financing of industrial development](#)," Policy Research Working Papers, World Bank, 1995.

⁴¹ Georg Rich and Christian Walter. "[The Future of Universal Banking](#)," *Cato Journal*, Vol. 13, No. 2 [Fall 1993], pp. 289-313, on p. 289.

⁴² Rich and Walter, p. 297, as of 1991.

⁴³ Munawar Iqbal, Ausaf Ahmad and Tariqullah Khan. *Challenges Facing Islamic Banking* [Islamic Development Bank/Islamic Research and Training Institute; Occasional Paper, 1998; available [online](#)], p. 65.

implement. Syed Nawab Haider 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 Sharicah-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 Sharicah (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 antisceptically ‘consequence-insensitive’ procedural way of thinking.”⁴⁴

Conclusion

IFIs proclaim that the conventional financing based on interest is unjust, because there is no fair sharing of profit/loss and risk. However, the IFIs themselves are not actually utilizing PLS modes in their portfolio to any meaningful extent. A good part of the problem relates to the parameters for the PLS modes in classical Islamic laws. Innovations can address the problems facing the IFIs, 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 appear to mimic the conventional finance. An important constraint ignored by the Islamic discourse is that partnership is the least common type of business organization, due to certain inherent problems associated with partnership. Those problems are real, and human behavior in such business organizational contexts is not irrational in avoiding the kind of PLS and risk-sharing modes.

The preoccupation with PLS modes stems from the presumed prohibition of interest and disliking for debt instruments in business. However, since problem might lie with this presumed prohibition in terms of interpretation and overly expanded scope, the IFIs end up coming with ruses (*hiyal*) to devise and offer products and services that are only legally Islamic or *shariah*-compliant, but in substance there isn't much difference between IFIs and conventional financial institutions. It is no wonder that conventional financial institutions are aggressively trying to grab their share of this niche market, because they can easily adapt the form, where in reality they have less risk and profit that is comparable to or better than what they earn in their conventional market.

⁴⁴ Syed Nawab Haider Naqvi. "Islamic Banking: An Evaluation," Finance in Islam website [undated; available [online](#)]

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