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ISLAMIC RESEARCH AND TRAINING INSTITUTE

FINANCING TRADE IN AN ISLAMIC ECONOMY

Research Paper No. 51

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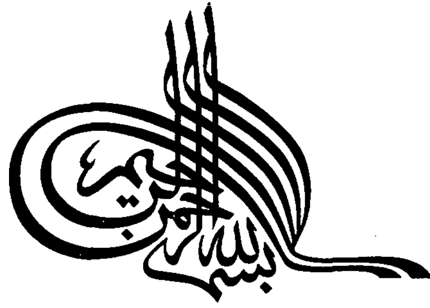

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FOREWORD

International and interregional trade occupies a strategic position in the development of economies. Historically speaking, continuous growth in per capita GNP has always been accompanied by an accelerated growth in trade. That is why, development economists have viewed trade as an engine of growth – a dynamic vehicle that propels and sustains the process of economic growth. However, more than two-thirds of world trade is controlled by the industrial countries. The proportion of Islamic countries in the total world trade was a meager 7 percent in 1996. The extent of intratrade among the Islamic countries is also not very impressive at 9.5 percent in the same year. In comparison to this, the intratrade among the industrial countries in 1996 was about 70 percent of total trade. Even, developing countries traded 54 percent of total trade among themselves during the same year.

These figures underscore the significance of trade in the development of Islamic countries. Obviously, expansion of inter- and intratrade among the Islamic countries is indispensable for the development of Islamic countries. That is why, the Islamic Development Bank (IDB) has made the promotion of economic cooperation and trade amongst the Islamic countries one of the main objectives of its strategic agenda in the medium-term. The IDB views the promotion of trade among the Islamic countries as a task, which requires multi-pronged efforts in different directions. Consequently, it has taken several steps for the promotion of trade among the Islamic countries. While financing of import and export trade occupies a position of prominence in overall operations of the IDB, it also has established several institutions with the same purpose in mind. These institutions include the Islamic Banks' Portfolio for Investment and Development, and the Islamic Corporation for the Insurance of Investment and Export Credit.

The present monograph on Financing Trade in an Islamic Economy was undertaken as a part of IRTI's annual research program. Dr. Ridha Saadallah, now Professor of Economics at the University of Sfax (Tunisia) but then a member of the Research Division of IRTI, implemented it.

The paper examines the issue of trade financing in a general framework. It has been noticed that Islamic banks mostly use *Murabaha* as a technique for trade financing. This study examines other possible methods of financing which may be used to finance the trade sector. The study blends juristic arguments with economic analysis. The study has succeeded in showing that, under some conditions, Islamic banks may be motivated enough to freely choose to use profit-loss sharing (PLS) techniques *(Musharakah* and *Mudarabah)* to finance trade transactions. However, sometimes, self-interest may not be strong enough to motivate the financiers to use PLS techniques. The divergence between individual and social interests, in this case, may provide enough justification for government intervention. The government, in such cases, may provide additional incentives to prompt banks to use PLS techniques to allow the traders to pursue socially beneficial trade credit activity.

It is hoped that publication of this monograph will stimulate further academic interest and scientific research in this area.

MABID ALI AL JARHI
Director, IRTI

I- INTRODUCTION

The consensus view of contemporary Muslim jurists identifying interest with the prohibited *riba* has led Muslims to search for appropriate institutional arrangements in order to restructure their economic and financial systems on the lines prescribed by Islamic *Shari 'ah.* As a result, a growing literature has developed with the aim of rediscovering the doctrinal foundations of Islamic economics and applying them to analyze the functioning of a modem-day Muslim economy. The area of Islamic banking and finance has naturally received the most attention by economists and practitioners, in view of its direct and profound sensitivity to the prohibition of the payment and receipt of interest. Alternative Islamic modes of finance have thus been developed, their comparative advantages assessed, and their applicability to various sectors and operations considered.

Little attention has, however, been paid to the financing of trade operations, from a theoretical angle. The literature in this field is mostly confined to critical comments on the observed practices of Islamic banks directing a great deal of their resources to short-term investments principally in trade and using predominantly murabaha-based techniques The present research is an attempt to fill this theoretical gap by bringing into focus the issue of the selection of the most suitable institutional arrangement to finance trade operations in an Islamic economy.

At this stage it would be useful to clearly state what is meant by trade financing in order to define the scope of the research.

First, trade financing is sometimes used in a narrow sense to refer to the financial support provided to international trade operations. In the context of the present research, we would rather refer to the broad sense of the term, including both domestic and international trade transactions['].

Secondly, trade financing is a restricted form of finance. It is tied to the acquisition of goods. The latter is used in a broader sense including not only the

purchase of goods, but also leasing operations where the rented goods are ultimately acquired by the lessee.

Finally, the term "financing" is sometimes used in the literature interchangeably with two closely related terms: credit and lending. This interchangeable use is however unwarranted, especially in Islamic economics. When associated with the exchange of goods, financing implies the lade of a simultaneous exchange of value. Accordingly there is trade financing whenever the goods are acquired against a promise of a future payment, or the price paid against a promise of a future delivery, or the goods acquired against the participation in future profits that may be earned from putting it into productive use. When the financing involves a promise of a future payment of the exchange value (the price or the goods), it takes the form of credit(2) . Therefore credit is only one form of financing and should not be identified with it. The other form is referred to as a participatory finance because the exchange value is a share in future profits. Lending is a particular form of credit where the delayed exchange value is the same loaned commodity, with or without a premium. Under *Shari 'ah,* lending cannot be used as a form of trade financing because it should be gratuitous. To sum up, the scope o the study covers the provision of funds by all permissible means, on credit or on participatory basis, for the purpose of acquiring all kinds of goods, domestic as well as foreign.

The research is based on the hypothesis that the predominant use of *murabaha* and similar credit techniques is neither inevitable nor a priori reprehensible. The paper will therefore attempt first to identify all permissible techniques that can be lawfully applied to provide finance to various types of trade transactions. It will then establish the conditions under which the demanders and suppliers of finance will freely choose between credit and participatory techniques.

In the attempt to identify the trade financing techniques that are permissible under *Shari 'ah* rules, the paper refers to a number of contracts which have their origin in the classical Islamic commercial law. However, being frequently used in contemporary Islamic banking literature, these contracts are introduced in the paper only briefly, assuming that the reader is familiar with the definitions and basic related conditions.

The study is composed of seven parts. Section II reviews the conventional methods of trade financing and identifies the salient features of conventional credit markets. These constitute a reference point for the analysis of the

alternative Islamic methods of trade financing that will be undertaken in the remainder part of the study. Section II examines the scope for using *murabaha* -based techniques as an alternative of the interest-based financing of trade. It concludes that *murabaha-based* techniques is a necessary component of an Islamic alternative system of trade finance. But it has to be supplemented with PLS modes of finance, at least to solve the refinancing problem that may face the traders who extend credit to their customers without the possibility of discounting the receivables when they need liquidity. In Section IV PLS-based solutions to the refinancing problem are developed. They include the issue by the traders of PLS securities placed directly in the market and the constitution of trading partnerships between banks and traders. The latter solution seems to be the most promising alternative to the discounting of receivables. Section V provides a comprehensive picture of the Islamic techniques of finance that can be used by traders or by financial institutions to finance various categories of goods. Section VI deals with the crucial issue of the bank's choice between the use of financial *murabaha* and other credit techniques on one hand and the recourse to participatory finance in association with traders on the other. It establishes the conditions which favor the use of PLS methods of finance and the factors that on the contrary limit its use. Finally, Section VII presents the main findings of the research and some concluding remarks.

II. FINANCING TRADE IN A CONVENTIONAL ENVIRONMENT

The need for trade financing arises when the buyer of goods wishes to defer the payment of the price or, although less frequently, when the seller requires the advance payment of money.

In an interest-based environment trade transactions are financed exclusively through credit, whether it is tied or untied to the commercial transaction.

Demand for credit emanates from both households and business concerns. A major part of households' demand for credit is to finance the purchase of houses. It typically consists of long-term collateral loans, also known as mortgages. Consumer credit is used by households to finance major purchases, such as cars and durables, as well as other. Purchases of consumer goods, particularly through the use of credit cards. Refinancing of debts incurred for such purposes is also considered as consumer credit. Most of consumer credit is on installment basis.

Business concerns demand short-term credit to finance their inventories or to refinance their accounts receivable. They may also need medium to long-term credit to finance their purchase of capital goods. Business firms engaged in international trade transactions demand credit to cover the price of their imports or to refinance the credit they would have extended to their foreign customers.

Credit needs of both consumers and business firms are primarily met through a variety of financial institutions: commercial banks, savings institutions, insurance and pension organizations, finance companies and credit unions. However, there are cases where these credit needs are satisfied without the intervention of financial intermediaries.

Firstly, large and creditworthy firms operating in developed financial markets may raise short-term funds directly from the money market by issuing commercial papers for the purpose of financing the purchase of inputs or the refinancing of the credit extended to their customers. These firms and, to a lesser extent, smaller size business concerns may also issue corporate bonds to raise from the capital market long-term funds to finance the purchase of equipments. Secondly, consumers may get their purchase of consumer goods financed directly by retailers. Though not a major source of consumer credit, this type of credit accounts for a fairly significant part of consumers total short-term borrowing. In the United States retailers credit accounted for 9% of total consumer installment credit outstanding at the end of the year 1984(3).

Last, but not the least, a major part of short-term borrowing by business concerns is extended by other business firms. This inter-firms credit, also known as trade credit, is used by almost all firms, but more substantially by small businesses. As an example, it accounts for approximately 40% of the short-term liabilities of American corporations(4), and over twice their short-term liabilities to banks. Considered from the lenders' side trade credit accounts for more than 25% of the total assets of US corporations. Trade credit is usually extended on very short to short terms. The credit terms typically leave to the buyer the choice between a discount for an early payment within a very short period (e.g. 7 days) and a full payment for a longer credit period (e.g. 30 days). Sellers may also offer terms whereby cash is due within a specified period with no discount for prompt payment (e.g. net 30). In the latter case, there seems to be no credit cost for the buyer since the same amount would be paid, whether or not credit is extended by the seller. However, the seller incurs inevitably an opportunity cost for extending credit. Depending on the market conditions, this cost may or may not be passed on to the buyer in the form of higher prices of the seller's goods. The cost of trade credit for the buyer appears clearly, though still implicitly, in the case of a two-part credit offer. Here the foregone discount is equivalent to the payment of an interest charge on the effective credit period, i.e. the difference between the net period and the discount period (23 days in the example above). An interest cost is explicitly charged on trade credit when it is materialized in a bill of exchange or a promissory note. This form of trade credit is more frequently used in international trade.

The existence of refinancing facilities is of a critical importance for the functioning of the credit markets in a conventional economy. The originators of credit are not always the ultimate providers of finance. For example business firms which distribute significant amounts of credit to other business firms or to

consumers do so only because they are assured of the possibility of refinancing to meet any liquidity needs. Indeed, firms look at their accounts receivable and short-term debt instruments (bills of exchange and promissory notes) as very liquid assets since they can be easily converted into cash. Bills and notes may be discounted with commercial banks, and accounts receivable may either be sold to a bank or a finance company (factoring or forfeiting) or be pledged as a security for a short-term bank loan Finance companies which play an important role in refinancing short term credits extended by retailers and other business firms are themselves refinanced through borrowing from commercial banks or issuing commercial paper in the money markets.

As pointed out earlier, loanable funds are provided by the full range of financial intermediaries; i.e. commercial banks, savings banks and associations, credit unions, pension funds, insurance companies and finance companies. It would be interesting to know whether or not this institutional diversity has enhanced competition in the credit markets. Available information seems to imply that credit markets are rather fragmented. First of all there are clear indications of specialization of different financial intermediaries in different slots of the market. Saving institutions for example are traditionally specialized in mortgage lending. About 60% of the total assets of American Savings and Loans Associations and Saving Banks were in 1990 for mortgage financing while less than 10% of their assets were made of consumer and commercial loans([5]. Pension funds and insurance companies do rarely compete for consumer and commercial loans and are specialized in low-risk and long-term investments. Finance companies are supposed to compete with commercial banks for short-term lending to consumers and business. But here also empirical investigations show little evidence, if any, of competition It is shown that wherever different and binding rate ceilings are imposed on banks and finance companies, the market tends to be segmented by risk, with the finance companies specializing in lending to riskier customers at higher rates. When 'there are no binding rate ceilings, the market is not segmented by risk classes. However, it is still fragmented. Banks specialize in providing finance to customers who are sensitive to interest rates while finance companies compete for customers who accept to pay higher interest rates against more flexible credit terms (e.g. size of monthly payment)([6]. The fragmentation of credit markets is also and more forcefully observed in developing countries, particularly in terms of rural/urban or formal/informal markets. This market fragmentation is attributed to the differences among classes of credit suppliers with regard to the information each one possesses on the capacity of a certain class of borrowers to meet its obligations. A lender who has stronger

information links with a particular borrower would have an edge over other lenders and would benefit from element of implicit monopoly rent,(7)

To conclude this section, it may be useful to recall some of the salient features of the conventional credit markets, so far as this can help in developing alternative modalities for the financing of trade transactions by Islamic banks. In this respect, the following may be pointed:

1. While financing trade, commercial banks do not assume any commercial functions. They confine their role to the pure financial intermediation.
2. Banks finance trade, domestic as well as international, in two ways:

   a) through direct lending to the buyers; and through refinancing the credit originated by the sellers. Refinancing may take the form of the discount of trade papers, the sale of the sellers' accounts receivable or the extension of loans to the sellers.

3. A significant portion of the funds needed by the buyers to finance their purchase of goods, is advanced by business firms. This financial intermediation assumed by non-financial firms raises questions about the efficiency of the credit markets, since financial intermediaries are supposed to have an advantage over non-financial corporations in retail credit because of the economies of scale and the benefits of specialization. But financial intermediation by business concerns may, on the other hand, open new avenues for Islamic banks to finance trade transactions through their association with business firms. It would therefore be important to identify the conditions under which business firms may effectively compete with traditional financial intermediaries in the credit markets.

4. Refinancing is of a vital importance for sellers' credit. Sellers who extend credit to their customers may of course keep the financial claims in their portfolios to maturity. But they frequently sell them for cash before maturity. In any case, sellers need to have the assurance of liquidating their receivables when needed without incurring an excessive cost. Otherwise, the sellers' opportunity cost would be higher and they wouldn't be able to offer competitive credit terms. In the absence of refinancing facilities, sellers' credit would therefore shrink if it wouldn't simply cease to exist. The

significance of this feature of the market would be brought to the fore when put in an Islamic perspective, because of the prohibition of selling claims at a discount.

5. There is little evidence of inter-institutional competition in the credit markets. Furthermore, credit markets exhibit in general, particularly in developing countries, some degree of monopoly power attributed to the asymmetry of information held by different classes of lenders.

III. MURABAHA AS AN ALTERNATIVE TO INTEREST FINANCING OF TRADE

In their quest of a viable Islamic system' of finance that *would* replace the illicit practices of 'interest financing, Muslim bankers turned towards its operationally . closest alternative: *"Murabaha.* However *murabaha* as 'inherited from Islamic jurisprudence, was not tailored to readily fit the needs of bankers and other financiers for a substitute financing technique. In the following paragraphs, we' will first recall' *how the 'concept of murabaha, as* a financial technique used by Islamic financial institutions, has evolved from the original contract of the same name. We will then discuss the ability of this financial technique *to* satisfy the' financial ' needs arising from *trade* transactions. More specifically, we will raise the question of the ability of *murabaha* to provide alone the alternative to the conventional interest financing of trade.

A) From *Murabaha to* Financial *Murabaha:* The Evolution of a Concept

Murabaha simply means mark-up sale. It is a particular type of sale that Islamic jurisprudence ' considers . as a trust contract; because the seller and the buyer do not negotiate the price, but rather agree on a certain profit margin added to the cost, as faithfully declared by the seller:

Originally, *murabaha, was* not conceived ,of as a mode: of finance, since it was not necessarily concluded on the basis of deferred payment. *Marabaha sale* for cash was the rule rather than the exception.

The shift to credit *murabaha,* or *murabaha* with deferred price, is a first requisite for its transformation. into a technique of finance. Credit *murabaha* can be *used* by non-financial firms to finance the purchase of goods by households and business concerns. Its, rise to a full-fledged financial technique used in the credit markets requires however further amendment of the original contract.

Indeed, banks and other financial institutions which would like to practice credit *murabah* would need to assume, more or less, a commercial intermediation function, in addition to their original function as financial intermediaries. They would, in fact, have to play the double role of intermediary buyer and seller between the ultimate buyer and seller. However, financial institutions are not specialized in commerce and they are not equipped to efficiently perform the economic functions of traders. Therefore, they would like to depart the least from their traditional financial intermediation function and to keep their commercial role to the strict minimum necessary to comply with Islamic principles. More particularly they would like to avoid holding inventories of goods and to market them over a prolonged period of time. This is achieved though the second amendment to the original concept of *murabaha,* that . is to say the requirement that the sale contract be preceded by the customer's promise to buy the desired goods, once they are acquired by the financier.

The resulting financing technique may thus be distinguished from the original *murabaha* sale on two grounds:

Credit is an indispensable feature, and not just a mere possibility. The existence, of a prior promise to buy [8] is a prerequisite for the extension of credit.

For the sake of clarity, we will refer to this financing technique as "*financial murabaha"*(9).

B) The Scope of *Murabaha* in an Islamic System of Trade Financing

It was shown earlier that the needs of both consumers and business firms for financing their purchase of goods were met either by financial institutions (personal loans, business loans and purchase of receivables), or by non-financial firms (trade credit and retailers credit), or directly in the financial markets (issue of securities by creditworthy firms). Credit and financial *murabahas* may partly fulfill the functions of these conventional techniques, but they cannot replace them fully.

To begin with, financial *murabaha* cannot be used for direct financing in the financial markets. The issue of murabaha-based securities would not serve the purpose either. Of course, one may think that financial institutions advancing funds on the basis of financial *murabaha* would be able to get the needed refinancing through the issue of this type of securities in the same way finance companies are refinanced through the issue of commercial paper. However, the attitude of financial institutions to avoid as much as possible dealing with merchandises, would make the assets structure of any financial *murabaha* fund highly dominated by

debts. Islamic principles prohibiting the profitable exchange of debts would therefore make such securities non-transferable, and their issue unfeasible.

On the positive side, credit *murabaha* provides an alternative to trade credit and retailers credit extended by business concerns to other business firms or to consumers. They operate in a very similar way, with two exceptions. On the one hand, in the case of a two-part credit offer (discount for early payment or full price for a longer payment period), the choice should be made in advance and the contract should be definite with regards to the selected terms. On the other hand, the deferred price is definite and the contract should make no mention of any additional cost on possible overdues[10].

Financial *murabaha* may also be used, and is actually used, as an alternative to banks' credit, if the latter is tied to the purchase of goods. However, Islamic banks and other financial institutions intervene in this market in a radically different way, as compared to conventional banks. On the one hand, while the latter have the choice between direct lending to the buyers and refinancing the credit originated by the sellers, Islamic financial institutions can only finance the buyers. Refinancing is excluded, as it amounts to the purchase of debts, on which no profit . can lawfully be made. On the other hand, while conventional banks assume a purely financial intermediation role, Islamic financial institutions using financial *murabaha* have to further assume some kind of commercial intermediation. It was noted earlier, that, by means of the promise to buy device, Islamic financial institutions may avoid building up inventories of goods. Furthermore, they usually mandate the prospective buyer to select the supplier of the demanded goods, to negotiate with him the terms and conditions o fl the cash sale contract and to check, on delivery, the conformity of the goods with the required specifications. This procedure minimizes for the financier the risk of buying goods that would be later refused by the customer. However, Islamic financial institutions have definitely to assume to some extent a commercial function and can't act as pure financial intermediaries. They assume the commercial risk attached to their ownership of the demanded goods for the period of time elapsing between their acquisition of the goods from the supplier to their delivery to the customer. This commercial risk is specific l to financial *murabaha* and can't be totally avoided, notwithstanding the above-mentioned devices aiming at limiting it. It adds to the credit risk (delayed payment or default) which-is common to both Islamic and conventional financial institutions. 'Furthermore, the commercial risk facing Islamic financial institutions may even be greater, incase the promise to buy is considered non-binding[11]. This is because an additional cost may be incurred for marketing goods' acquired on-the basis of a prior promise to buy, that the customer refused later to honor.

(C) The Consequences of the Absence of Refinancing

The earlier' discussion on the conditions of financing' trade in a conventional financial system, has shown that the existence of refinancing facilities' is almost -a prerequisite for the distribution of sellers' credit. Business firms financing trade on the basis of credit *murabaha* have the same needs of financial support to enable them to extend credit to their customers. As the sale at a discount of claims arising from credit *murabaha is* not licit, business firms operating in a pure *murabaha* environment(12) would cease extending credit. This situation is however' neither feasible nor economically efficient. Trade credit is indeed intimately linked to trade itself, Traders view credit as an indispensable device to promote and expand sales. Therefore, it would be practically inconceivable to confine traders in the exchange of goods' and to concentrate the financing of trade: in the hands of financial institutions. Moreover, the observed growing importance of' trade credit in the developed market economies seems to imply that the provision of credit by business firms is efficient under certain market conditions. The elimination-of trade credit in a *pure murabaha* system would thus mean a loss of efficiency.

It appears clearly from the' above discussion that, due to the absence of refinancing facilities, murabaha-based modes cannot provide - alone the alternative to the interest-based financing of trade transactions. Having admitted that an ' Islamic system' for trade financing cannot be made solely of *murabaha*-based modes, one may ask whether it can' do without' them? The answer is no; there are cases where the use of credit or financial *murabaha* is indispensable. It is obvious in the case of non durable consumer goods; they simply cannot be financed' otherwise than through credit *murabaha* from the seller or through financial *murabaha* from an Islamic financial institution. Other goods may be acquired- on *non-murabaha* basis, but if the user prefers to buy them on credit, then the only solution available is to use, murabaha-based techniques:

In summary, it may be said that an Islamic system of trade financing can neither be made exclusively of *murabaha* nor do completely without it. It is necessarily a mix of financing techniques.

IV. ALTERNATIVE SOLUTIONS TO THE REFINANCING PROBLEM

In the previous section, it was shown that the exclusive use of *murabaha*-based techniques lead to a refinancing problem for the waders who extend credit to their customers, because once the credit is extended, it becomes a debt that cannot be sold at discount without violating the *Shari'ah* rules. One may however think that the problem may not arise if Islamic banks become directly involved in trading activities. Banks are thought to dispose of a thick liquidity cushion that would make the recourse to refinancing unnecessary. This solution presents nevertheless serious drawbacks, as it will be shown shortly. Traders' credit should therefore remain in the system, and solutions need to be devised to the impossibility of refinancing sellers' credit. Trade refinancing may be looked at as a financial backup provided by banks and other financial institutions to sellers subsequently to their extension of credit. The common principle underlying the development of Islamic alternatives to conventional refinancing involves the replacement of the subsequent financial backup with a prior financial support provided to the sellers. Contrary to conventional refinancing, which is based on the discount of debt instruments, the alternative prior support is based on the profit-and-loss sharing (PLS) principle. Sellers may obtain the needed support either directly in the financial markets through the issue of PLS certificates or from financial intermediaries. It will be shown below that the latter solution, where financial institutions become the partners of traders, seems to be very promising.

A) The Bank as a Trader

Some Islamic economists tend to think that Islamic banks need not to simulate the modus operandi of conventional banks, thus operating basically as financial intermediaries. Instead, Islamic banks are advised to become involved in real[13] business, and especially trade. This would be achieved either through merchant departments staffed with adequate commercial skills or through the

establishment of merchant subsidiaries(14). The principal advantage attributed to this way of doing business is that Islamic banks would assume the business risk implied by the trade activity and draw there from an income which is unambiguously *riba-free.* One cannot underestimate this advantage of the bank-trader method over the. *murabaha'* method, as presently practiced in Islamic' banks, in terms of their relative compatibility with *Shari 'ah.* However, the bank-trader method is seriously objectionable on macroeconomic and social grounds. Furthermore, it does not solve in all cases the financing problem:

To begin with, Islamic banks raise mostly short-term funds. They cannot therefore use them, beyond certain limits, in long-term investments like the acquisition of equity capital in trade subsidiaries.

Second, the suggested method would , lead to the establishment of financial empires controlling and dominating a large part of the economy. At the same time, it would subjugate. the traders to powerful financial institutions. It is well-known that the ensuring monopoly power is the source of both economic waste. and social injustice. As a matter of fact, 'financial institutions are in many . countries. not allowed to subscribe to the capital of business concerns, and in the United States, the Glass-Steagall Act prevents commercial banks from indulging in investment banking and. particularly holding equity shares issued by business concerns(15).

Third, the bank-trader method implies obviously a loss of the benefits of specialization.

Finally, the bank-trader method solves the refinancing problem, only if it takes the form of merchant departments.. But, when Islamic banks establish trade subsidiaries,- these are financially independent from the mother-institutions. Thus, if the subsidiaries need liquidities to refinance the credit they had already. extended to their customers, they find themselves exactly in the same situation as any other seller vis-a-vis the resources of the mother-banks.Therefore the establishment of trade subsidiaries does not eliminate the need to design appropriate methods to support financially the credit activity of traders. As pointed, out earlier, such methods are of two kinds: one class of methods is based on the partnership between sellers and financial institutions, banks in particular. The other one is based on the issue by the sellers of profits-and-loss sharing securities.

B) The Bank as Partner

1. The Purpose of the Partnership

In the context of the present section, partnership between traders and banks is meant to provide the sellers with an Islamic alternative to interest-based refinancing of trade debt('". Its purpose is to allow the sellers to extend credit to their customers beyond what is permitted by their own resources.

Banks may enter in partnership arrangements with sellers at all levels: producers, wholesalers and retailers. Exporters, extending supplier's credit to their foreign customers as well as importers reselling on credit to their national customers may also benefit-from this form of financial backup provided by Islamic banks on PLS basis.

2. The Subject Matter of the Partnership

The bank and the seller will contribute, jointly .and .according to pre-agreed, proportions, the capital needed to buy certain well specified goods and to market them. .

The raised funds may be assigned for the following uses:

i) To Buy for cash domestic or foreign goods for subsequent resale on credit.

ii) To buy for cash domestic or foreign capital goods for subsequent leasing (17)

iii) To buy on advance payment finished goofs for subsequent resale on cash basis.

iv) To buy on advance payment finished, goods for subsequent resale on credit.

It should be pointed out that in the case the financing is provided to a producer, the subject matter of the partnership, is the purchase of already produced goods for ,subsequent resale on credit The peculiarity of the case is that the producer will buy for the partnership and on its behalf his own goods. The validity of the transaction requires that the partnership is charged a fair price *(thaman al-mithl)* for the purchased goods.

3. Types of Partnership

Methods of financing based on the idea of partnership between traders and financial institutions may be distinguished according to the form and the scope of the partnership.

According to the first criterion, one may distinguish between *mudaraba* and *musharaka* partnerships.

Mudaraba is normally an association whereby one party, the investor, provides . the capital and the other party, the agent manager, provides his efforts. In the context of the trader-bank partnership, it is obvious that the trader will be the agent-manager. However, bank may not like to finance fully the subject-matter of the partnership and prefer that the trader gets a financial stake in the project in addition to his efforts. Similarly, traders may not always require full financing of their transactions. They may prefer using in priority the available internal resources, and look at the banks only to fill the gap. The *Hanbalis* refer to this particular form of *mudaraba* where the agent-manger is also an investor as *sharika-wa-mudaraba.* But other schools of *fiqh* call it simply *mudaraba.* In this arrangement, the bank as an investor does not intervene in the daily management of the partnership and cannot impose a priori restrictions that would paralyze the trader's liberty of actions. The bank may never the less impose any other conditions that would preserve its interests It has also the right to control the faithful implementation of the contract and to check the accuracy of the *mudaraba* accounts.

In *a musharaka* arrangement, the capital is naturally contributed by the two parties, the trader and the bank. Both are also supposed to contribute their efforts. However, one might expect in a trader-bank partnership that the bank would use its intervention right only on exceptional basis and for control purposes The trader would, on the contrary, provide most of the managerial work This kind of arrangement is permissible under the *`inan* type of *sharikat,* according to the *Hanafis* and *Hanbalis* teachings(18) .

The differences between the two arrangements are, in the present context, minimal. In both cases, capital is contributed by the trader and the bank. The trader will provide management exclusively in the case of *mudaraba* and principally in the case of *musharaka.* Entitlement to profits and responsibility for losses are governed by the same principles: The manager (trader) is entitled to a certain share in the profits for his efforts, but does not bear any losses,

except in the cases of negligence, willful wrongdoing or non-compliance with the terms of the partnership[19] . The remaining part of the profits and all the losses are shared among the partners in proportion to their shares in the capital. May be the most important difference between the two arrangements is that, in a *musharaka,* the bank keeps the right to intervene in the management of the project each time it is deemed necessary, in spite of the delegation of authority given initially to the trader. On the contrary, in the case of *mudaraba,* the bank loses its intervention right, once the conditions stipulated.

In addition to this dual classification in *murabaha* and *musharaka,* trader-banks partnerships may be further classified according to the scope of the association. Accordingly, partnerships may be concluded for one transaction, or for all transactions of a specified nature concluded during a certain period of time. In the first case, the partnership is terminated at the end of the cash-conversion cycle o the goods, i.e. once the goods sold and their proceeds collected In the other case, the partnership is terminated on the agreed maturity, whether the capital is again converted fully into cash or not. The latter may better suit the operational requirements of the banks, though it is not without raising some *Shari'a* issues. Partnerships with fixed duration are certainly permissible for the *Handballs* and the *Hanafis*[20]. But a problem arises when part or all of the capital is not converted into cash on maturity. The problem would be solved if the traders were almost certain of their capacity to market the financed goods and to cash the price before or on maturity, or alternatively if the principle of estimated evaluation (tandid hukmi)) was admitted. Unfortunately, this principle is not clearly accepted in the traditional fiqh, though it is widely practiced in Islamic banks, particularly with regards to the yearly determination of the profits attributed to the *mudaraba* accounts. Subject to confirmation of *Shari'ah* specialists it will be assumed in the remaining part of the paper that it is permissible for the banks to backup the credit activity of traders on the basis of fixed duration PLS methods.

To establish the suitability of PLS modes as an alternative to conventional refinancing of traders, two further issues need to be addressed. On one hand, there is the problem of entitlement to profit of the assets owned by the trader but used by the partnership. On the other hand, one may question the flexibility of PLS finance to meet the variable financial needs of traders.

4. The Relationship between the Partnership and the Trader's other Assets

The capital of the partnership covers the direct costs of purchasing and marketing the financed goods. However, the trader as a manager of the partnership will use his own assets such as transportation vehicles, warehouses, handling equipment, etc. He may also use his own personnel (salespersons, accountants, cashiers…..,) to market the merchandises of the partnership. These factors, though external to the partnership, contribute along with the capital to any profits that may be realized from the sale of the financed goods. Their costs should normally be born by the partnership or alternatively entitled to share in the profits. Two cases should be differentiated according to whether the trader's assets and personnel are used exclusively by the partnership, or they are concurrently used for other activities of the trader, alone or in association with other financiers.

a) The Case of Exclusive Use

In this case, variable expenses, such as wages, rent of assets not owned by the trader, are obviously charged to the account of the partnership.

As for the assets owned by the trader, they may be rented to the partnership. But as the trader is the decision maker in the partnership, the renting of his own assets would be validated only if the rental is fair *(ujrat-almithl).*

Alternatively, the assets may be made available to the partnership against a higher share of the trader in the profits. It was pointed out earlier that the trader is entitled for his work to a share in the profit over and above his share as a capital provider. The remuneration of the assets would be included in the share of the work, on the assumption that the assets provided by the trader are considered as his instruments of work.

b) The Case of Concurrent Uses of the Assets

This case raises the issue of apportioning the common costs of the trader's assets among their various users, including the partnership The apportioning is necessarily arbitrary to one extent or another. Therefore, it may not be permissible, particularly in the case of *mudaraba.*

Three alternative solutions may be suggested for this problem. The first solution considers that the work provided by the trader is not limited to his personal management but also includes all the material and human resources assisting him in performing his work. In return, he would obviously be entitled to a higher share in the profits.

The second suggested solution, valid only for *musharaka* type of partnership, involves the combination of two contracts. The first contract is a *musharaka* contract between the trader and the bank according to which the two parties will contribute the capital needed to just cover the cost of purchasing the goods and conveying them to the warehouses of the trader. The latter will not perform any additional work under the *musharaka* contract. The profits will therefore be shared proportionately to the capital. Now, the partnership, as an independent entity, will enter with the trader in a marketing contract whereby the latter will take all necessary actions to market at the best possible conditions the goods entrusted to him by the partnership. He will bear all the costs entailed by this marketing activity and will be paid in return, agreed upon fees. The marketing contract may take the legal form of jo*'ala.*

The third solution is based on the opinion of the *Hanafis* and the *Malikis*(21) validating(the contribution to the capital of a partnership with the services rendered by an asset, while the asset itself remains the property of his owner Applied to our case, the trader will have three different contributions: part of the capital, the services rendered by his assets and his work, while the bank will contribute the remaining part of the capital. The trader will therefore be entitled to a further share in the profits for the services of the assets but will ensure that these services are effectively provided and consequently bear all the related costs.

c) The Suitability of PLS Techniques as Alternatives to the Refinancing of Sellers' Credit

In an interest-based system the seller takes two different decisions at two different times. First he decides a the time of the sale on whether to extend credit to the customer or not, and in the affirmative on what terms. This decision is normally taken in the light of a pre-established credit extension policy. Then, the seller will have to decide to keep the resulting claim in his portfolio until maturity or to sell it at a discount. Since this refinancing decision may be taken at any moment between the time of the sale and the maturity of the claim, the seller is able to respond in a flexible manner to any unexpected changes in his

liquidity position. If money is suddenly tight, the seller may sell more claims and improve his liquidity position. On the contrary if the seller is unexpectedly overliquid he may hold more claims in the portfolio.

In a PLS Islamic system, the timing of the two decisions is reversed. Before buying the goods that will be subsequently sold on credit, the seller should anticipate his sales and the demand for credit, adopt a credit extension policy and estimate the amount of external finance needed to implement that policy. A partnership contract with the bank is therefore concluded prior to the purchase of the goods while the credit to the customers will be extended at the time of sale. It is clear that if the expectations regarding the demand for the sellers' goods and/or credit will prove later to be mistaken, the seller may be locked in undesirable positions of either excess or short liquidity.

If the partnership technique was to be adopted by traders as an alternative to. bank refinancing, the above rigidity would need to be removed. One way to do it is to consider that the capital subscribed to at the beginning of the partnership would not be paid up in full. Part of it would be callable by the trader when a need arises. Furthermore the trader may at any time use his excess liquidity to pay back part of the capital contributed by the bank, thus increasing his share in the partnership. The profits and losses would be shared on the basis of the amounts contributed and the duration they remained with the partnership. This suggested solution is also inspired from the current practice of Islamic banks with regards to investment deposits. It should however be ensured that it does not violate any established *Shari'ah* principle.

C) The Issue of PLS Securities

1. The Basic Principle

The method of issuing profit-and-loss sharing securities is based on the same concept underlying the previous method which is to provide the seller with external resources on PLS basis in order to allow him to extend credit to his customers over and above his own resources. The main difference is that, in this case, the seller taps a wide range of savers - individual as well as institutional - for the needed finance, instead of relying on his bilateral relationship with a financial intermediary.

2. Nature of the PLS Securities

A PLS security is a title of ownership of a common share in the net worth of a project; and as such it shares in the profits and losses that may arise from the project's operation.

The object of ownership varies according to the nature of the project in which the proceeds of the sale of the issued securities are invested, and also to the stage of investment. A seller issuing PLS securities will invest the raised funds in buying goods for cash or on advance payment and reselling or renting them on deferred payment basis. The net worth of the project is therefore composed either of cash, commodities, debts or a mix of them. For instance, if a seller issues certificates to buy *salam* goods that he will resell on credit, the certificates would undergo five stages: When the certificates are sold and not yet invested, they represent common ownership of cash and when the goods are bought, they represent common ownership of debts. Later when the goods are delivered but not yet sold, they represent common ownership of commodities. When the goods are sold on credit, they become again common ownership of debts. Finally when the debts are collected, the certificates return to their original status as representative of common ownership of cash. When the certificates finance [a] flow of operations of the same type, the stages will be mixed up, and, except for the initial stage, the certificates will represent at any stage an aggregate of cash, commodities and debts

2. Types of PLS Securities

Similarly to the types of partnerships, the securities issued by the seller to finance his trade credit activity may take one of the following forms:

i) One transaction *mudaraba* certificates

ii) Fixed term *mudaraba* certificates

iii) One transaction *musharaka* certificates

iv) Fixed term *musharaka* certificates

The maturities of fixed-term certificates should coincide with the dates of publication of audited accounts of the projects in which they are invested. Admitting the principle of evaluation as a substitute to liquidation, the holders

of the certificates will, on maturity, share in the profits or losses as they appear in the audited accounts.

4. Negotiability of the PLS Securities

Shari'ah rules do not permit the sale of title representing the common ownership of only debts or money. Furthermore titles representing a mix of debts, money and real assets are negotiable only if the real assets are dominant(22)

Negotiability of PLS securities issued by a seller varies according to the type of operations in which they are invested. Certificates issued for the purpose of buying capital goods for subsequent lease are negotiable all the time except for the very short period separating the sale of the certificates and the purchase of the goods. On the contrary, one-transaction certificates issued for "refinancing" credit sales start to be negotiable once the goods are possessed by the seller but loose their negotiability as soon as the accumulating debts become dominant. In the case of certificates issued to "refinance" the credit sales of a trader during a fixed period of time, the intermingled schedule of purchases and sales makes the negotiability of the certificates unknown a priori. All depends on the weight of the inventories in the financial aggregate owned by the holders of the certificates.

Negotiability of the certificates is also subject to the general conditions of validity of sales contracts, particularly the condition of knowledge of the subject-matter. of the contract. As it is admitted that the certificates are not exchanged per se, but for what they represent, the sale of certificates should only occur when sufficient information is available on the assets and liabilities of the project in which the certificates are invested(23). This is admittedly the case after audited accounts of the project are made public. But could it still be. the case if the certificates are exchanged more frequently and even continuously, as is the practice in the financial markets? Would it be possible to reasonably assume that the administration ' of the stock exchange makes available to the buyers and sellers of the certificates instantaneous relevant information that would avoid an exorbitant want of knowledge *(jahl fahish).* The final word is left to. the Islamic Jurists, but one could not refrain from tentatively replying in the negative(24).

5. Obligations of the Seller as an Issuer of Certificates

The issue of PLS certificates creates *ipso facto* a do a partnership between the seller and the buyers of the certificates. The announcement of the issue is considered as a public offer of intent *(Ijab)* and the subscription of investors as an acceptance *(Qabul)*. The announcement should therefore, contain all the terms and conditions required for a partnership contract. The seller should clearly indicate the transaction or activity for which the certificates are issued and the method of determining and distributing the profits and losses. A feasibility study containing in particular the expected return will be attached to the prospectus(25).

The seller should keep separate. accounts for, the partnership. All the purchase, lease and sale contracts concluded by the seller on behalf of the holders of the certificates should clearly mention that the goods are owned by the partnership and therefore, unambiguously separated from other assets owned by the seller. The Law regulating the issue of PLS certificates should ensure that the issue of certificates suffice for the legal establishment of the partnership without the need of any specific registration.

The seller should indicate in the prospectus announcing the issue of the certificates, whether they are deemed negotiable or not. In the case of negotiable certificates, the seller should guarantee that real assets of the project will at no time become less than 50%. If the certificates may become non-negotiable at some future dates, the seller will undertake to inform the holders of the certificates of any change in the structure of the net worth which may prevent their negotiability.

6.The Case of Different Issues Financing the same Activity

A seller may like to finance his commercial activity by issuing certificates at regular intervals, say quarterly. The proceeds of different issues may be used to finance the same transactions. This may be the case for example when the purchase of a quarter are financed with the proceeds of that quarter's issue in addition to part or the proceeds of previous issues which have completed the cash conversion cycle. This raises the issue of the entitlement of different issues' certificates to the end-period result Two cases may be differentiated according to whether the issues and the publication of audited accounts are synchronized or not.

a) The Synchronization Case

It is assumed here that the seller is able to produce and publish audited accounts periodically, say every quarter. The issues are issued at the same periodicity (e.g. the quarter) and for maturities which are multiples of the basic period Certificates of different issues will have the same face value, but newly issued certificates will be subscribed at the book value of old certificates as it appears from the audited accounts or at the market value if they are exchanged in the secondary market Profits and losses will be shared in the same way by the holders of old and new certificates; i.e. proportionately to the face value of their certificates(26). This method is theoretically equivalent to the dissolution of the partnership at the end of each period and the start of a new one. The new subscribers will therefore share only in the profits and losses generated after they join the common pool

b) The Diachronic Case

In this case, the seller is supposed to need issuing certificates at a frequency which is higher than the periodicity of publishing audited accounts For instance, he may need to issue certificates quarterly while he can produce audited accounts only annually.

Sharing in the profits and losses proportionately to the face value of the certificates held by each investor, irrespective of their dates of issue, is of course unjust. The alternative is to consider that each certificate shares in the profits and losses declared at the end of the year proportionately to the product of its duration and its face value(27). This again is inspired from Islamic banks practice of sharing the profits among the holders of *mudaraba* accounts in proportion to both the amount invested and the duration of investment. Contrary to the previous case, the holders of new certificates share in the result of the whole year activities in which they and the old certificates are invested and not solely to the outcome of the operations conducted after their subscription.

7. Benefits and Limitations of PLS Securities with Respect to Trade Financing

The attractiveness of financing by the means of issuing securities in general lies in its ability to satisfy the liquidity preference of the savers and the need of the firms for stable investments. Negotiability is however of a vital importance for the securities to perform their function of transforming short-term savings into medium to long-term investments.

As pointed out earlier, the negotiability of PLS securities issued by the sellers is expected to face serious difficulties, among which the following two may be mentioned:

i) the absence of organized stock markets providing the required information for the negotiability of the certificates;

ii) The variable structure of the financial aggregate owned by the certificates, with the possibility for cash balances and debts to become at some stages dominant preventing thus the negotiability of the certificates.

Furthermore, the issuance of PLS securities by the sellers may itself face difficulties. On the one hand, for an issuer to place successfully his certificates, he should inspire the confidence of savers. This implies a strong financial basis and sound accounting and auditing procedures. Even in developed economies, it was noted that only very strong firms can actually issue commercial paper. On the other hand, PLS certificates are risk sharing and it would be very risky for an individual investor to put his money in a single transaction or even in the activity of a single seller. It is, therefore, expected that only banks and other institutional investors who can hold a diversified portfolio, would subscribe the sellers' PLS securities.

Finally, it appears that the issuance of PLS securities is mostly a theoretical alternative to interest-based refinancing. Under the prevailing conditions, it would be put into practice only marginally to finance leasing operations. Banks-traders partnership would rather dominate as an Islamic alternative to conventional refinancing.

V. THE COMPLETE SYSTEM OF ISLAMIC MODES OF TRADE FINANCE

In an Islamic system, trade transactions may be financed either on credit or on participatory basis. Credit involves the deferment of the price or of the delivery of the purchased commodities. Credit may be extended either by business firms or by banks and financial intermediaries. The same techniques of credit can be used by both types of financiers. The only difference between the two is that banks' credit is always preceded by the beneficiary's promise to buy or to rent the financed goods. Participatory finance involves the participation of the financier in the profits and losses brought in by the means of either reselling the financed goods or incorporating them into an income generating production process. Participatory finance is normally the preserve of financial intermediaries, because business firms would, in normal circumstances, prefer to provide their customers with the required credit rather than sharing with them the risks inherent in their activities. Financial institutions may provide participatory finance either to the buyers of the goods or to the sellers. In the latter case it is considered as a form of financial support which allows the sellers to extend credit to their customers over and above their own resources. It was shown earlier in this paper that this form of finance is practically a necessary condition for the existence of sellers' credit.

Trade finance, whether credit or participatory, may be of different maturities. Business credit is usually short-term, while bank finance may be short-term as well as medium-term. As for long-term finance, Islamic banks would not be in a position to provide it directly to any significant extent, due to the short-run dominated structure of their resources. They may however contribute indirectly through the participation in investment funds.

Finally, financing trade transactions may be concerned with two different categories of commodities: standard and divisible goods on one hand and large

and buyer-specific capital goods on the other. Different techniques may be needed to finance those two different types of commodities.

To start with, we will review in what follows, the financing modes that can be applied to provide short to medium-term credit or participatory finance for the acquisition of standard commodities. Then, we will take up successively the special cases of financing the buyer-specific commodities and of the longer-term finance.

A) Short to Medium-term Credit to Finance Standard Commodities

Credit, whether extended by banks or by business firms, may take various forms. For the kind of transactions considered in the present paragraph, the relevant credit techniques include credit *murabaha,* financial *murabaha,* installment sale, *ijara-wa-iqtina* and *salam.* The first two were reviewed in Section m above and need not be detailed anymore, except to say that they may be applied to finance the purchase of all kinds of goods on short-term. The remaining techniques will be briefly presented below:

1. Installment Sale

Installment sale is a form of credit sale where the deferred price is paid in installments over a certain period of time. Theoretically, it may be based on *musawamah* (negotiated price) or on *murabaha* (negotiated margin added to a declared cost). Practically, Islamic banks using this technique adopt the *murabaha* type. Installment sale is appropriate for the medium-term financing of equipments where the size of the financing justifies its splitting up in many installments.

Producers of capital goods and traders of durables may sell on installments to their customers, provided they are assured of the support of their banks. Banks may also use this technique for the same purpose. They would however require, as in the case of financial *murabaha,* that the customer undertakes to buy the goods beforehand Banks may not be able to expand much in this type of medium term financing; their ability to transform short-run resources into longer-term uses is certainly limited

2. Ijara-wa-iqtina

This involves the lease of equipment over a certain period of time and the transfer of ownership to the lessee at the end of the period. The transfer may be effected either on grant or on sale basis. Usually, the lease contract is associated with the financier's promise to grant the leased equipment at the end of the period or to sell it at its residual value.

Ijara-wa-iqtina is not known as such in the traditional fiqh but appears to be a combination of two lawful contracts: a rent contract on one hand and a grant or a sale contract on the other[28].

This mode of finance is also appropriate for the medium-term financing of equipments. It is therefore a close substitute for installment sale. Its use by sellers or banks is subject to the same conditions and constraints.

3.Salam

Salam is "a sale with advance payment for future delivery" [29]. *Salam* may have various financial uses[30]. In the field of trade finance, it may be used as an indirect financing of the purchase of raw materials and intermediate goods. If a producer needs to finance his purchase of inputs, he would agree with a trader, e.g. a wholesaler or an exporter, to sell him with advance payment finished goods identical to his own[31]. The trader financier is supposed to specialize in the marketing of the same type of finished goods. Thus, he would not require the existence of a warranted demand before financing the producer. This is not the case of a bank providing the same type of finance. Indeed, a bank is not interested to receive the financed goods at the delivery date. It would therefore require that someone undertakes to buy the financed goods from the bank at the delivery date. It seems that *salam* is more appropriate as a trader's finance than as a bank's finance. Of course, here as in other types of traders' credit, banks will have to play a role to support the credit activity of traders on partnership basis.

B) Short to Medium-Term Participatory Finance of Standard Commodities

The development' of the previous section have shown how participatory finance can be used by Islamic banks to provide the required support to the

sellers' credit activity. In the following paragraphs, we will show how Islamic banks can also provide participatory finance directly to the buyers.

Banks may enter into partnership arrangements either with traders or with producers.

1. Banks-Middlemen Partnerships

The purpose of this type of partnership is to give the trader the means to buy for cash finished goods for subsequent resale also on cash basis. The financing is provided to the trader as a buyer and should conceptually be differentiated from the financing provided to him as a seller to enable him to extend credit to his customers. In practice, the two forms of financing may be confused and the bank may enter with a middleman into a partnership with the purpose of buying goods for cash or on advance payment and selling them on credit.

Banks-traders partnerships are operationally the same, whether the trader is considered as a seller or as a buyer. The classification of the partnerships according to the legal form and the scope of association, which was undertaken earlier[32] remains valid here too.

The type of partnership considered in the present paragraph is particularly appropriate for the financing of importers, considered as buyers of foreign goods. It is actually practiced in Sudan, particularly by the Sudanese Islamic Bank, for the financing of domestic and foreign trade on *musharaka* basis[33]

2. Banks-Producers Partnerships

The objective of this type of partnership is to provide the producer with the funds required to buy raw materials, intermediate goods or capital goods necessary to carry on his productive activity.

Contrary to the partnerships presented earlier, the financed goods are not, in the present case, acquired simply for resale but rather to be part of a production process, the outcome of which - profits or losses -will be shared between the bank and the producer

In the context of trade finance[34], the financed equipments are seldom used independently. Usually, it is a question of acquiring some equipments for

expansion, modernization or replacement purposes The newly acquired equipments will contribute jointly with existing ones to the production activity of the beneficiary Therefore, it wouldn't be possible to identify profits that can be separately attributed, to the partnership. This inseparability problem is also raised in the case of partnership financing of the purchase of production inputs. Here also, any profits that may accrue are a joint product of the partnership and other factors external to it, such as the equipments owned by the producer.

Assuming that the producer is not willing to include his own equipments into the partnership, as to be entitled to a share in the profits, the problem may be solved on the basis of the idea of *musharaks* with the services rendered by the fixed asset while the asset itself remains the property of his owner. It was pointed out earlier that this type *of musharska is* validated by the *Hanafis* **and** the *Malikis*[(35)]

The bank-producer partnership will therefore take the form of *sharikat inan,* the capital of which is composed of:

i) the funds provided by the bank for the purpose of buying the equipment(s) and/or the inputs;
ii) the funds contributed by the producer for the same purpose; and
iii) the services provided by the real assets owned by the producer and utilized by the partnership.

If the partnership contract assigns the management to the producer, the profits would be shared in fours, one for the management and one for each one of the three components of the capital. The expenses needed to make the real assets render the services expected from them are born by their owner, i.e. the producer.

C) The Long-Term Finance of Buyer-Specific Commodities

This is the case of a producer who needs to finance his purchase of capital goods that are not readily available with the supplier because they have to be tailored to meet the specific requirements of the buyer. These customized equipments are in general large items necessitating relatively huge investments. The supplier would therefore insist on getting a firm order and partial advance payment.

The financing of this type of commodities may still be provided by the seller, if he is adequately backed up by a bank on PLS basis[36]. But since the demanded commodities are not available when ordered, there should be at the start a reciprocal promise to buy and to sell followed by a sale contract when the goods are produced. The supplier would not however invest in producing customized commodities if the buyer's promise is not considered binding. This requirement is however much debated among the Islamic jurists. Moreover, this solution cannot accommodate the seller's requirement for partial advance payment of the price, because such payment amounts to paying part of the price before the sale contract is concluded.

Another possibility that may be considered for the financing of buyer-specific capital goods is the bank-buyer partnership on the lines suggested in the previous paragraph. This technique is however subject to the same reservations as the first one.

It seems that the most appropriate techniques to meet the particular requirements of financing the purchase of buyer-specific capital goods are built around the contract of *istisna'.* Two such techniques will be presented below.

1. Istisna'-cum-Installment Sale

The prospective buyer makes to his bank a promise to buy specified goods, once they are acquired by the bank. The bank concludes with the producer of the goods an *istisna'* contract to manufacture the goods according to the buyer's specifications. When the goods are manufactured and accepted, they will be sold on installment basis to the buyer who made the promise.

Istisna' is closely related to *salam* but is more flexible[37]. In particular, the price may be paid at the time of the contract, at the time of delivery or gradually. This flexibility permits to meet the manufacturer need for down payment.

One weakness of the suggested technique is that *istisna* is considered by the majority of Islamic jurists as a non-binding *(ja 'iz)* contract. There is however an opinion ,within the *Hanafi* school which makes it binding for the orderer of manufacture to accept the manufactured goods if they are found to meet the required specifications[38]. The other weakness is related to the Shari 'ah acceptability of the technical requirement to make the buyer's promise binding.

2. **Two-tier Istisna'**

This is the combination of two *istisna* contracts. The prospective buyer asks the bank to manufacture a certain equipment with well defined specifications. The price in this first contract is deferred The bank asks a specialized manufacturer to manufacture the equipment according to the buyer's required specifications. The payment of the price to the manufacturer may be gradual, if he needs to finance the production stage.

D) The Longer Term Finance of Capital Goods

It was pointed out above that banks may face difficulties to finance trade transactions for rather long periods, due to the short term nature of their resources. At the same time, some capital goods require a certain gestation period before they start generating profits. Therefore they must be financed on medium to long-term basis.

Counting on the observation that the outflow of maturing short-term deposits is usually, more than balanced with an inflow of new deposits, banks may use short-term resources to provide long term finance This "transformation" should however be operated with caution and only to a limited extent, for fear of facing serious liquidity problems[(39)].

A more dependable alternative would be to provide medium and long-term finance indirectly through "Investment Funds".

The objective of these funds is to raise money for medium and long-term finance through the issuance of negotiable securities40[(40)], thus reconciling the liquidity preference of the investors and the need of the business firms for stable and longer-term finance.

Investment funds may be established as banks' subsidiaries or as independent financial institutions. They are organized alternatively on the lines of *musharaka* or *mudaraba.* They issue shares or *murdaraba* certificates of different maturities.

Investment funds provide medium and long-term finance to business firms on credit or participatory basis along the same lines developed earlier with respect to bank finance. Banks would therefore contribute indirectly to meet the medium and Long-term financial needs of traders through holding a portfolio of

shares and *mudaraba* certificates issued by investment funds[41]. This indirect method of financing has the decisive advantage of allowing the banks to respect their liquidity constraint. This is achieved by the means of two factors:

i) the possibility to form a portfolio that matches the maturity structure of the bank's deposits and the purchased securities;

ii) the possibility to liquidate part of the portfolio to meet any net outflow of deposits that may occur unexpectedly.

The whole range of financing techniques that can be used to meet the financial requirements of the trading sector is summarized in Exhibit I below:

A BRIEF ACCOUNT OF THE METHODS OF FINANCING TRADE TRANSACTIONS IN AN ISLAMIC FRAMEWORK

Beneficiary	Sellers' Finance		Banks' Finance	
	Financier	**Techniques used**	**Techniques used**	
Consumers	Mostly retailers	Credit Murabaha	Financial Murabaha	
	Ditto	- Credit murabaha - Installment sale; and -Ijara-wa iqtina)I&I)	- financial murabaha; -Installment sale; and -I&I on prior promise	
Middleman	Build up Inventories	Producers and wholesalers	- Credit murabaha and - Installment sale	- financial murabaha; -Installment sale; and -I&I on prior promise -PLS (bank-buyer partnership)
	Supporting the beneficiary's credit Activity (refinancing)			PLS (bank- seller partnership)
Producers	Purchase of inputs	- upstream producers (producers of the inputs); - wholesaler - downstream producers (buyers of processed goods) or -middlemen specialized in Marketing the processed goods	- Credit murabaha - Salam (promised goods)	-Financial murabaha; - PLS (bank-buyer partnership); and - Salam (purchase of processed goods on the basis of a third party's promise to buy the same goods
	Purchase of standard capital goods	- equipment producers; - traders; or -leasing companies	- Installment sale; and - I & I.	- Installment sale; -I & I on prior promise; and - PLS (bank-buyer partnership)
	Purchase of buyer- specific capital goods (down payment required)			- Istisna –cum- installment sale (on a binding prior promise to buy); and - two-tier istisna
	Supporting the beneficiary's credit activity (refinancing)			PLS (bank-seller partnership)

* Also includes indirect finance through investment funds in the case of medium to long-term financing of capital goods.

To sum up, an Islamic system of trade finance is characterized by the following features:

i) the system admits both credit and PLS methods of finance;

ii) business credit needs to be supported by financial institutions and the only way this support can be provided is on PLS basis;

iii) banks may provide PLS finance to the buyers for the purpose of covering the cost of the purchased goods or to sellers for the purpose of supporting their credit activity;

in general, banks provide finance directly to the beneficiaries; but, when the maturity is rather long, finance may be provided indirectly through investment funds;

v) banks may either confine their role to financial intermediation through partnership arrangements with traders or carry out, in addition to that, some functions of the traders through selling and buying on credit. The advantages and disadvantages attached to these two courses of action will be compared below.

VI. BANKS' CHOICE BETWEEN CREDIT AND PLS FINANCE

Banks financing trade transactions on Islamic principles may intervene in the market through providing credit only, PLS finance only or a combination of the two. It was shown that the first alternative is socially unacceptable, because it nearly eliminates trade credit for lack of refinancing facilities and leads to the domination of the credit market by a handful of powerful financial institutions. It would therefore be expected that the regulatory authorities in an Islamic economy would ensure that Islamic banks will adequately assist traders in their role of credit providers. It was shown above that this assistance is necessarily provided on PLS basis since the sale of receivables at a discount is prohibited. Islamic banks are thus left with two options; to leave the credit market to the traders and to specialize in PLS finance, or to combine both PLS finance and credit.

Bank's specialization in PLS finance is more in line with their traditional role as financial intermediaries. Furthermore, it presents the attractive advantage of sparing Islamic banks the need to operate on the basis of a much debated legal opinion that considers the promise[42] made by the bank's customer a binding one. However, if Islamic banks can extend trade credit without violating any *Shari'ah* rule, the choice between credit and PLS finance would be made on the basis of purely economic considerations. However favored by Islamic banking theoreticians, PLS finance would displace bank credit to traders only if it is more profitable for the providers of funds.

A number of arguments may be advanced for the preferential use of PLS finance by Islamic banks, the most important of which being the possibility provided by PLS finance for banks to share in the comparative advantage which is supposedly held by sellers in offering trade credit. But there are also other factors that are supposed to hinder the widespread use of PLS finance. One of the most repeatedly cited inconvenients of PLS finance is that it involves a moral hazard problem for the banks using it.

1. The Financial Motive for Trade Credit as an Incentive for the Use of PLS Finance

The important role played by trade credit in the economy testifies that, under certain conditions, business firms may be motivated to extend credit to their customers at terms that cannot be matched by financial institutions. One may therefore presume that, under the same conditions, banks may find it profitable to associate with business firms for the purpose of extending credit.

Though different explanations have been advanced for the use of trade credit,(43) the literature recognizes that its use beyond very short periods, in the range of thirty days,(44) implies the existence of a financial motive. It would be the case if the seller extends credit to his customers with the aim to increase his present-value profit. It is obvious that Islamic banks participation with sellers requires that the latter act upon the financial motive, alone or in addition to other motives.

The existence of a financial motive for offering trade credit is attributed to financial markets imperfections. In a perfect capital market, the buyer will be indifferent among all sources of capital, because the rate he is willing to pay equals the rate a bank or a seller would actually charge; the seller is unable to profit from offering credit to the buyer(45)

Two theories of trade credit based on the existence of a financial motive generated by capital market imperfections are found in the literature.

Emery (1984) argues that when the firm operates in an imperfect capital market,_ excess borrowing and insolvency costs require the constitution of a liquid reserve. A seller with a liquid reserve may use part of it for trade credit at an opportunity cost equal to the "market lending rate of interest", itself equal to the banks' cost of capital. On the other hand, sellers enjoy a comparative advantage over banks in terms of transactions costs that characterize an imperfect capital market. Therefore, sellers may profitably link financial intermediation to the sale of goods. This theory of trade credit is based on the conjunction of two assumptions: the requirement of a liquid reserve and the sellers' lower transactions costs.

Schawrtz and Whitcomb (1979) attribute the sellers' financial motive to their advantageous access to capital compared to buyers and also to their transactions costs advantage over competitive lenders. This theory does not assume however the prior constitution of a liquid reserve:

Both theories may, with some amendments(46), provide the basis for analyzing the conditions under which Islamic banks may profitably use PLS methods to finance trade transactions. The following paragraph will establish these conditions under the assumption that both buyers and sellers have equal access to financial markets in the sense that they are charged the same cost of funds by financial institutions. This assumption will be relaxed in the second paragraph

2. The Case of Equal Access to Financial Markets

The effective use of PLS finance requires the fulfillment of two conditions. First, sellers should find it more profitable to extend credit to their customers in association with Islamic banks rather than using only their internal resources. Second, banks should also prefer the financing of trade transactions through their association with the sellers to the direct credit to buyers.

a) The Seller's Demand for PLS Finance

Cash flows associated with a firm's activity are uncertain and irregular. A mismatch between cash inflows and outflows could cause liquidity problems. In an imperfect financial market, a solution of these problems could be found only at the price of higher costs. Finns need therefore to constitute a safety margin that is provided by earmarking part of their resources to the acquisition of liquid assets that could rapidly and at a low cost be converted into cash. Part of the constituted liquid reserve should be kept in cash form to meet the cash outflow requirements. The remaining part may be invested in near-wash earning assets such as short-term government securities,[47] short-term deposits in *mudaraba* accounts or accounts receivable.

The investable portion of the liquid reserve is an available source for investment in receivables. The opportunity cost attached to this form of finance is the rate of return on alternative uses of funds. We assume that the expected rate of return on *mudaraba* deposits "i" is a fair approximation of this opportunity cost [48].

Assuming that the availability of trade credit affects positively the amount of sales and that the seller is a price-taker in the credit and product markets, the optimum supply of output "Q" and of credit "K" will be determined simultaneously by maximizing the present-value profit of the seller, given the price of the output "p", the mark-up "r" and the transactions costs attached to trade credit "13"

The seller compares the investible portion of the liquid reserve "L" to the optimum amount of credit "K". If the former is sufficient to cover the desired amount of credit (I>K), the seller would not demand any financial contribution from the bank because the bank's required return is necessarily higher than the seller's opportunity cost "i". If, on the contrary the investible portion of the liquid reserve is insufficient (K>L), the seller will fill the gap either by reducing his real asset investments at an opportunity cost "k" or calling upon Islamic banks PLS finance, in which case his opportunity cost will remain "i". Since the return on real assets is most likely higher than the return on banks' deposits[49] (k>i), the seller will prefer PLS finance for filling the gap[50]

In brief, there will be a demand for PLS finance, if the optimum amount of trade credit is larger than the investible part of the liquid reserve.

b) The Bank's Supply of PLS Finance

The bank's choice between providing credit to the buyers through participation with the seller or directly is determined by the relative profitability of the two options. The bank's opportunity cost is the same in both cases. It is the expected return on *mudaraba* deposits "i".

If the bank chooses to extend credit directly through financial *murabaha,* it will charge a mark-up "r" equals to the return that it can obtain from alternative uses of funds. The difference between "r" and "i" is the equivalent of the spread between the market borrowing and lending rates of interest. The literature interprets the spread as the image of the transactions costs incurred by financial institutions in performing their credit activity. They include the information and collection costs. The spread must also account for the remuneration of the work of the bank, or "normal" profit, but this factor is only implicitly recognized. When barriers to entry exist in the market, banks can obtain rents which add to the spread.

If the bank chooses PLS finance, it will share in the revenues generated by the credit activity of the seller, i.e. the mark-up charged by the latter to the buyer. The mark-up is equal to the maximum the buyer is willing to pay to obtain trade credit from the seller. Since the buyer can alternatively obtain credit from the bank at the rate "r", this rate will be the maximum he would pay for the seller's credit. The bank will also share in the transactions costs incurred by the seller when he provides credit to the buyer. These costs " are supposed to be lower than the bank's costs attached to the same credit operation "--0". However, the bank incurs also other transactions costs attached to the decision of entering into partnership arrangement with the seller. These costs "7-", fully born by the bank, are needed for the appraisal of the application for partnership as well as the monitoring of the operation to ensure the accurate reporting of the profits and losses.

To establish formally the condition under which the bank will choose PLS finance over direct credit, let:

K_F=K-L the capital committed by the bank either for credit or for participation with the seller.

L = . the capital contributed by the seller to the partnership.

1-X = K the share of the seller in the capital of the partnership. L

a = the share of the profits attributed to the seller for his commitment to manage the partnership[51].

it = Profits of the partnership.

RR, = The bank's rate of return on direct credit.

RR_p = The bank's rate of return from partnership with the seller.

The bank's rate of return on direct credit can be written as:

$$RR_c=r-8-i$$

Profits generated by the joint investment of a capital K in trade credit is:

$$n=(r-13)K$$

The bank's share in these profits is equal to:

$$(I-a)\ (r-(3)\ K= (I-a)(r-13)\ K_F$$

The rate of return on the bank's investment in the partnership is therefore:

$$RRp=(1-a)r-(3)-y-i$$

The bank will choose PLS finance if:

$$RR_p > RR_c$$

$$(1 - a)(r - (3)-y-:i>r-6- 1 \qquad (1)$$

The interpretation of this condition becomes straight forward, if we ignore temporarily the remuneration of the seller's management (a=0). In this case condition (1) is rewritten after simplification as follows:

$$0-(3>y \qquad (2)$$

Condition (2) means that a necessary condition for the bank to choose PLS finance over direct credit is that the assumed seller's advantage in terms of transactions costs is enough to outweigh the additional transactions costs incurred by the bank to appraise and monitor the partnership.

The reintroduction of the remuneration of the seller's management makes the condition on the magnitude of the direct transactions costs incurred by the bank more stringent. This can be seen from the following rearrangement of condition (1):

$$0-3>y+a(r-(3)>y \qquad (3)$$

It appears clearly from the above discussion that the bank's choice is critically dependent on the assumption that sellers have an advantage over banks in terms of transactions costs attributable to trade credit ((3<0). We will examine in the next paragraph the arguments given in the literature in support of this hypothesis.

c) Causes of the seller's lower transactions costs

At the root of all advantages attributed to the sellers in terms of transactions costs lies the fact that trade credit is a restricted form of finance confined only to the seller's customers(52).

Sellers can economize on both information and collection costs. A first component of information costs is incurred in the process of searching profitable business opportunities. Here one may observe that while financial institutions incur search costs in terms of advertising expenditures, a seller who extends trade credit requires no search because the beneficiary is already a customer of the seller's product

A second component of information costs is related to the assessment and the monitoring of the default risk. In this respect the advantage of the seller is multifarious. First of all, information on the buyers' creditworthiness is generally a by-product of sales activities which require the analysis of customers' demand as well as their ability to pay. Second, lags in the payment system are such that what is considered a cash receipt is actually a delayed payment, but for a very short period, a week or so. Sellers need therefore to collect information on the default risk even for "cash" sales. The marginal information cost of trade credit is thus reduced and may very well be close to zero. Thirdly, sellers deal with a homogeneous group of customers with whom they have regular and frequent contacts. Their specialization in credit analysis reduces the cost of learning the default risk as compared to banks and credit investigation firms. The frequency of contacts with the buyers and the possibility to compare information gathered from different customers in the same industry, allows the seller to adjust more quickly should a default risk arise and thus to economize on the cost of monitoring the default risk.

Coming to the collection costs, the seller has a twofold advantage. On the one hand the risk of default or protracted payment is minimum as compared to the bank, because the buyer who defaults would jeopardize his long lasting trading relations with the seller. On the other hand, whenever the financed goods can serve as collateral, the seller would have the possibility to repair or rework the repossessed unpaid goods and distribute them through his usual commercial channels. A bank placed in the same situation would on the contrary incur a higher collection cost because it cannot depend on its own distribution channels and may have to dispose of the repossessed unpaid goods at distress prices.

To sum up, it is clear that the sellers enjoy a substantial advantage over financial institutions with respect to transactions costs attributed to trade credit. It remains to know whether this advantage is substantial enough to outweigh the additional cost a bank necessarily incurs when it chooses PLS method of financing trade. It will be shown below that even if this is not the case, banks may profitably supply PLS funds to sellers, provided that the buyers are rationed on the financial market while sellers are not.

3. The Case of The Sellers' Advantageous Access to Financial Markets

Empirical research provides the evidence of widespread quantity rationing in credit markets[53]. Credit rationing occurs when financial sector firms choose or are forced to refuse providing the demanded finance instead of charging higher prices.

A first explanation of credit rationing is provided by the existence of regulatory constraints preventing banks from adjusting the cost of credit to the risk level embodied in the financial transaction. Usury ceilings are an example of such constraints in a conventional system. In an Islamic financial system rationing may also occur if the regulatory authorities impose ceilings on the markup charged by Islamic banks on financial *murabaha* operations.

A supplementary explanation of credit rationing is attributed to asymmetric information, i.e. the divergence of the sets of information available with the financiers and the beneficiaries regarding the risk of default. Asymmetric information results for banks in moral hazard and adverse selection problems. Moral hazard arises when the beneficiary adopts a post-contractual opportunistic behavior and increases the risk of default after receiving credit. Because banks expect a positive correlation between the size of credit and the default risk, they would face the moral hazard problem by reducing the size of credit extended to any given beneficiary, thus resulting in credit rationing. As for the adverse selection problem, it may arise because when banks attempt to adjust to higher risks by raising the cost of funds, they may end up with a riskier pool of customers. Banks facing such adverse selection problem would therefore respond to higher risks by credit rationing rather than by higher costs of capital[54]

Sellers are less prone to use credit rationing for two reasons: The first is. that they may not be subject to the same regulatory constraints as financial institutions. The other is that, unlike banks, sellers deal with a homogenous and

well-known pool of customers. They are, therefore, less likely to face moral hazard or adverse election problems. .

Now suppose that a buyer is rationed in the credit market, but that one of his suppliers is not. This means that at the market cost of capital "r" the buyer is not receiving the optimum amount of credit. He would be ready to pay to any other 'source of finance a higher rate of return "r_B" to receive more credit. The seller may do it and internalize the difference between the rate of return on the credit extended to the buyer, "r_B", and the rate of return required by the bank on its participation with the . seller, "r". The bank's .choice will be between extending a suboptimal amount of credit to the buyer and, providing in association with the seller the optimal amount of credit to the buyer. Using the notations of the previous paragraph, the bank will choose the PLS method if:

$$(1 - a)(rB-P) - y> r-O '. \qquad (4)$$

Ignoring the remuneration of the seller's management (a=0), this condition amounts to:

$$Y < (e - B) + (rB-r) \qquad (5)$$

This condition means that the bank may cover the additional transactions costs resulting from the use of PLS finance from two sources: the seller's transactions costs advantage and the spread between the value of trade credit for the rationed buyer land the market cost of capital.. '

A) The **Moral Hazard Problem Embedded in PLS** Finance

In banks-sellers relationships a moral hazard problem may arise whenever the seller tends to under-report ,the true realized profits("). Under-reporting is possible because the true profits are either unobservable or too costly to be observed. In *mudaraba* contracts, banks are ' supposed to refrain from intervening in the management of the partnership and therefore unable to observe the realized profits. In *musharaka* contracts; the bank has in principle the right to intervene on an equal footing with the' seller in the affairs of the partnership. However, as 'pointed out above,([56]) the bank usually delegates its management rights to the seller and intervenes only when necessary. In this case the bank accepts to bear the under-reporting risk because the costs of observing the true profits are in its view too high.

The reality of the moral hazard problem attached to PLS finance cannot be denied. However its extent should not be overestimated for the following reasons:

1. Islamic norms and values should deter Muslim entrepreneurs from behaving differently from what is required for a faithful implementation of the contract[57]. The more Muslims are effectively committed to the norms of Islam, the more the problem of moral hazard is reduced. However, it is not expected to disappear, since Muslims are subject, like any human beings, to deviations from the norms.
2. The bank is not helpless before the risk of under-reporting the true profits. It can require that the accounts of the partnership be audited by auditors of its choice. The seller may also be asked to provide a collateral to cover the risk of violating the terms of the contract[58]. These safety devices are not of course costless. In our formulation of the bank's 'choice between PLS finance and direct credit, these costs are a component of the bank's additional transactions costs "y" and are put against the benefits of PLS finance.
3. Trade is likely to be the least exposed activity to the risk of under-reporting profits, because of. the relative simplicity of the sector's "production" process as compared to manufacturing activities. Information on the sector's average costs is easily obtainable. Any substantial departure of the costs declared by the seller from the sector's average would reveal, ex-post, a dysfunctional behavior. In this case the fear of losing reputation and disrupting long lasting trade relations may provide a strong incentive for the seller to refrain from miss-reporting profits[59].
4. The 'moral hazard problem is more likely to arise in the case of individual - firms or family businesses where the ultimate control rests .with a small family group of major shareholders. In large shareholding companies where ownership is independent from management, the reporting of profits "becomes exposed to various administrative checks and controls, and normally no single individual may have a relative information advantage in that reporting process" (60)

5: Credit, the alternative to PLS finance, is not free from a moral hazard problem. Knowing that the bank cannot, in accordance to *Shari 'ah,*

impose interest on overdues, the seller may be tempted to adopt an opportunistic behavior and delay the payment of his debt(61).

B) Miscellaneous Factors Affecting the Bank's Choice of PLS Finance

In addition to what has been stated above, there are some other factors that are looked at as advantages of PLS modes or as disadvantages of credit modes. They represent as many incentives for PLS use. Among such incentives, the following may be mentioned:

1. A bank which extends credit, e.g. financial *murabaha,* plays a passive role. It waits for the promise to buy instead of searching actively for lucrative affairs. On the contrary, the seller is an active searcher for profitable trading opportunities. This divergence of behaviors may provide the bank with an opportunity to benefit from its association with the seller. However, this opportunity may not materialize, if the seller is able to capture, through the portion of the profit which is supposed to remunerate his efforts, the totality of the business component of the markup(62).
2. Banks are not specialists in the exchange of goods. They incur higher contracting and transactions costs as compared to traders when they deal in goods. Financial *murabaha* involves two sale contracts in addition Ito a promise to buy "contract". They result in higher costs than that of the single sale contract implied by the use of PLS finance. In addition to higher contracting costs, the use of financial *murabaha* may subject the transaction to a double sale tax.
3. The use of credit does not provide the flexibility required to meet situations where the seller is unable or unwilling(63) to market the financed goods before the credit comes to maturity.
4. Buyers may be reluctant to demand financial *murabaha* because they fear. that the intrusion of the bank into an old and well established relationship with their suppliers would ultimately deprive them from receiving some fringe benefits they used to get from that relationship. When this is the case,(64) the use of financial *murabaha* may result in a sub-optimal demand for credit.

In contrast with the preceding factors, the use of financial *murabaha is* assumed to provide the bank with the advantage of buying only on the basis of a

known demand the risk of having to dispose at distress, prices, unsold goods is minimum, if ' not zero. This disincentive for the use of PLS .finance would however disappear if the partnership with the seller is for a fixed term and if the seller undertakes to buy the unsold goods when the partnership comes to maturity maturity.

VII. CONCLUSION

The main purpose of the present research was to identify the most suitable institutional arrangement to finance trade transactions in an Islamic economy Trade is traditionally financed from two main sources: business firms and financial sector firms, with the latter constituting the ultimate providers of funds through factoring and similar sale of debts techniques.

Attempts to bring the system of trade financing closer to Islamic principles started with the replacement of interest-based bank lending with *murabaha* finance provided by Islamic banks. However, financial *murabaha* cannot by itself provide the Islamic alternative to the interest-based system of trade financing. An Islamic system of trade financing maintains the traditional complementarily of the two sources of finance and adds to it a complementarity of techniques: credit and participatory finance.

As for the first type of complementarity, it is recognized that business firms need to extend credit to their customers for four main purposes:

i) to promote sales;
ii) to increase present-value revenue through internalizing financial market imperfections and exploiting their information costs advantage over banks or their advantageous access to capital (financial motive);
iii) to increase present-value revenue through circumventing regulatory or market-induced restrictions on price competition (pricing motive); and
iv) to reduce present-value costs of response to unexpected or seasonal fluctuations of demand (operating motive) as well as costs of monitoring and enforcing trade-related contracts (contracting motive).

It would be economically inefficient to deprive traders from the possibility of exploiting their comparative advantage in providing finance to their customers. It would also be socially undesirable to displace fully suppliers'

credit and to concentrate the financing of buyers in the hands *of* few powerful financial institutions.

The complementarity of the sources of finance requires, in an Islamic system of finance, the complementarity of techniques. Neither credit nor profit-and-loss sharing methods can form alone the vehicle for financing trade. This is due to two factors. On the one hand, sellers cannot do without credit techniques when they finance the purchase of goods that are not intended to be used in an income-generating process. On the other hand, sellers do not have, in an Islamic system, the possibility to factor their receivables to meet an unexpected need for liquidities. In the absence of an appropriate alternative, the opportunity cost of trade credit would increase abruptly, should a need to liquidate a claim before maturity arise. This would discourage to a great extent traders from performing the needed financial intermediation function. An Islamic alternative to discounting claims arising from trade credit is therefore needed, *if* sellers were to maintain their trade credit activity. And the only alternative available is the use of profit-and-loss sharing arrangements between sellers and Islamic banks.

Having established that both credit and participatory methods of finance should necessarily coexist in an Islamic system of trade financing, it remains to know to what extent should Islamic banks make use of PLS modes when they provide funds to the buyers.

Full specialization of Islamic banks in PLS finance is supposed to present some attractive advantages. One of them is that it conforms to an efficient division *of* labor between traders and financial institutions; each group specializing in the activities where it holds a definite comparative advantage. Financial institutions would not deal in the exchange *of* goods where they are at a disadvantage compared to traders and these would deal in credit only as an adjunct to their principal trading activity. The other advantage of full specialization is that the use of murabaha-based finance does not require the reliance on a prior promise to buy, whether binding or not [(65)]. Hence, the use of *murabaha* based techniques becomes unambiguously in line with the Islamic *Shari 'ah.*

However, in a free choice environment, Islamic banks would decide to specialize in PLS finance only *if* they are motivated to do so. Assuming that a bank is convinced that both credit and PLS finance are legitimate from the *Shari 'ah* point of view,[(66)] its choice between the two is subject to the effect of

each alternative on its profitability. The choice will depend on the net impact of various factors including the following:

i) The size of the sellers' advantage over banks in terms of transactions costs attached to trade credit;

ii) The existence of rationing in the credit market affecting the buyers but not the sellers;

iii) The size of additional transactions costs incurred by Islamic banks when they use PLS finance;

iv) The size of additional contracting and transactions costs attached to Islamic banks' particular form of credit (based upon a prior promise to buy or to lease);

v) The size of additional costs attached to Islamic banks' credit when the promise to buy or to lease is not binding; and

vi) The impact of the under-reporting risk.

Islamic banks would weigh these factors in order to decide whether they would prefer PLS finance over credit or not. The assessment of the relative weight of the costs involved in the above factors requires the conduct of empirical studies. The task is however, difficult because it requires the development of customized data from non traditional sources[67].

The findings of the research point out to the existence of a potential source of conflict between the objectives of the bank and the objectives of the society. It is indeed possible that the net outcome of the various factors mentioned above would be an absolute preference for credit techniques, while it is socially desirable, as shown before, that Islamic banks get involved in PLS finance, at least in support of the traders' credit activity. An additional source of potential conflict may arise if the banks' choice of a particular mode of finance is not neutral for the economy as a whole. If the selection of PLS methods instead of credit modes has a positive impact on real macroeconomic aggregates,[68] such as the growth rate, the product-mix of the GDP or the income distribution, then the free choice of a profit-maximizing bank for credit modes would lead to a socially sub-optimal situation. The question is how such conflicts should be solved if and when they arise?

A conventional response to the divergence of individual and social objectives is provided through government intervention. It is argued that there

may be a case for corrective government policies whenever market imperfections prevent the "invisible hand" from bringing into harmony the selfish decentralized microeconomic decisions and the Pareto optimum. Consequently, the government may adopt policies that would prompt banks to take optimum-compatible decisions; i.e. -to use PLS methods of finance. Such correcting policies include the provision of subsidies to banks and the adoption of cost-reducing measures.

The corrective government actions to induce optimum-compatible banks' decisions are still required in an Islamic environment. But here the question is whether banks should not bear also some responsibility in coming closer to the optimum. In other words should Islamic banks still behave as profit-maximizers if the outcome is sub- optimal or should they accept less than maximum profits in order to come closer to the optimum? Islamic economics literature admits that the legitimacy of the pursuit of self-interest should be bounded by the moral values of Islam[(69)]. However, as far as Islamic banks do not use questionable means, there seems to be no rationale for them not to pursue a profit-maximization objective. They may be even more forcefully required to do so, given their status of trustees investing the funds deposited with them by others.

To conclude, it may be stated that the present research has succeeded to show that, under some conditions, Islamic banks may be motivated enough to freely choose to use PLS methods to finance trade transactions. But even when the self-interest motivation is not strong enough, the government should provide the required additional incentives to prompt the banks to use PLS finance at least to the extent needed to allow the traders to pursue their socially beneficial trade credit activity.

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Endnotes

(1) It should be admitted that it is not the intention of the paper to deal with international trade in a comprehensive way, sine this would need to take into consideration the fact that external parties to international trade are not necessarily bound to respect Islamic Laws. However, as far as international trade is financed b y Islamically guided entities, the solutions develop, din the paper equally apply to internal and external trade.

(2) Encyclopedia Britannica defines credit as a "transaction between two parties, in which one (...) supplies money, goods or securities in return for a promised future payment b y the other (...!)".This definition clearly admits as a credit both the sale with a deferred price and the sale with advance payment for future delivery.

3) See Tapscott (1985); Table 1, p.14.
4) See Rao (1989); p 644. The figures may vary from one country to another, but it is thought that trade credit accounts in all countries, developed and developing, for a non-negligible part of short term credit to firms.
5) See Kolb & Rodriguez (1992); pp 107 – 108.
6)See Sullivan (1984).
7)See Virmani (1982).

(8) It is usually accompanied with a reciprocal promise to sell issued by the financier, though it isn't theoretically a necessary condition for the existence of this financing technique.

(9) When first ' introduced (Homoud; 1982), this financing technique was termed ***"Murabaha*** Sale for the Orderer of Purchase". But the usage tended to prefer to it the much. shorter term of *"murabaha* thus leading to blur the distinction between the original meaning of the word and its new acception. The term "financial *murabaha",* suggested -here, has ' the double advantage of shortness and clarity. It evokes the known distinction' between "lease" (operating lease) and "financial lease"..

(10) However, the idea of imposing ex-post fine on delinquent debtors is 'currently debated among Shari 'ah Jurists.

(11) Contemporary , Muslim jurists hold divergent views with regards to the binding or non-binding nature of the promise to buy or to sell. This divergence of views is reflected in the practices of Islamic Banks, some of which do not consider the customer's promise binding, while others do.

(I2) Pure *murabaha* environment means here a financial environment where only ***murabaha-based*** techniques are used.

13) As opposed to monetary transactions.

14) See Aspinwall and Eisenbeis (1985), p.667.

15) See for example Omar (1992); p.65.

16) .Partnership may also be used by Islamic banks as a form of direct finance. In this case the partnership will be with the buyers. See Section V.

17) The form of leasing considered here as a trade financing technique involves the sale of usufruct of an equipment associated with a promise to sell or to give the equipment to the lessee at' the end of the lease' period (called in the contemporary literature Ijara-wa-iqtina), this financing technique is practically very close to an installment sale of the equipment.

18) See lbn Qud[a]ama, *al-Mughni, Vol.* 5, p.26 and Ibn Abidin, *Radd al-Muhtar,* Vol. 4, p.312. . ,

19) He loses of course the opportunity cost of his work as a manager. ,

20) A minority opinion within the *Hanafi* school does not accept the validity of *Musharaka* with fixed duration.

21) See Ibn Qudama, *al-Mughni,* Vol.5, pp.7-8, and *al-Muaq, at-Taj wal-Ikleel,* Vol.5, p.124.

22) See Resolution 5 of the 4t[h] session of the Council of the Islamic *Fiqh* Academy.

23) See Hassan (1990), p.39.

24) The same would also apply to the sale of common shares.

25) See Hassan (1990), p.36.

26) Except for the issuer who is entitled to a higher share for his work.

27) Since all certificates are issued at the share face value, this method amounts to share the profits proportionately to the duration.

28) The *Fiqh* Academy approved one form *of Sara-wa-iqtina,* in which the lessee will be given the option to buy the leased property at the end of the lease contract and at the market price. See Resolution No. 6 of the fifth session of Council of the Islamic *Fiqh* Academy.

29) See Saleh (1992); p.89.

30) See Omar (1992).

31) Traditional *Fiqh* requires that the subject matter of a *salam* contract should not be the Product of a designated field or orchard (or factory) because its availability may be in Doubt at the time of delivery

32) See section IV, paragraph A-3 above.

33) See Khaleefa (1993); pp.41-42

34) As opposed to projects finance.

35) see section IV, P.14

(36) The financing of this type of commodities is generally provided on medium to long-term basis. The conditions under which banks may get involved in this type of finance will be discussed in the next paragraph

(37) For more details, see Dunia (1990)

38) See Dunia (1990); p.35.

39) It may be noted in passing that Islamic banks are less incited than conventional banks to use tier-matched portfolios, because they are less exposed to the "interest rate risk"

40) Negotiability of the securities issued by investment funds is subject to the same comments made above with respect to PLS securities issued by traders.

41) Investment funds securities may be subscribed not only by banks, but also by other institutional as well as individual investors.

42) Promise to buy or to lease a certain goods, once it is acquired by the Bank.

43) For a survey of the alternative explanations of trade credit sue, see Emery (1988).

44) See Ferris (1981); pp.260.

45) See Schawrtz and Whitomb (1979); p.261:

46) The required amendments are due to the fat that conventional theories express the value of credit for the buyer and its costs for the financier in terms of interest rates.

47) Attempts are being undertaken to develop government securities that would provide an alternative to the interest-bearing government bonds. ,

48) It is the equivalent of the market lending rate of interest in an interest-based financial system.

49) Otherwise, the seller would prefer to cease trading and deposit all his capital with banks.

50) Banks usually require a minimum level of the beneficiary's contribution. If the liquid reserve is not sufficient to meet that level, banks would not fill the entire **gap,** and the seller would . need to reconsider his maximization problem in the light of this additional constraint. However, the condition for the existence of a demand for PLS finance would remain basically the same.

51) The remaining profits are supposed to be shared proportionately to the contributed capital.

52) See Emery (1984), Emery (1987), and Schawrtz and Whitomb (1979).

53) See Schawrtz and Whitomb (1979); p.264.

54) See Jaffee (1989).

(55) Under-reporting of profits does not necessarily aim at harming the interests of the partner. It may be induced by excessively high customs duties or business income taxes.

56) See paragraph B. 3, Section IV.

57) Kazarian (1991) underrates this distinctive characteristic, arguing that it is not needed when the terms of the contract can be enforced by law". He forgets however that legal enforcement of contracts is costly. See p 128.

58) Collateral requirement in *a mudaraba* contract is condemned only when it is meant to guarantee the capital and/or the profits to the provider(s) of funds. But it is legitimate when its purpose is to guarantee the faithful implementation of the contract. This nuance is overlooked in Kazarian (1991); see p.127, footnote. 27. .

59) See Khan W.M. (1987); p.94.

60) See Taj el-Din (1991); p.60.. .

61) Subject to the reservation., expressed above with regards to the implication of the beneficiary's adherence to Islamic norms of conduct.

62) The markup charged by a trader on a credit. sale, has ,two components:

- A business component which represents the profit that he would have realized if he had sold the same good for cash and
- A financial component attributed to the payment delay.

63) Waiting for example for more profitable opportunities to sell.

64) It is particularly the case of traders dealing with foreign suppliers.

65) In the perspective of full specialization, *murabaha* finance is used exclusively by traders.

66) Either because it does not consider the promise as binding or because it is convinced of he correctness of the.; view held by some Jurists who consider the promise to buy as binding.

67) It is reported by Emery (1988) that even conventional trade credit theories were not tested particularly-because of the stringent information requirements.

68) Such impact is frequently claimed in Islamic economics literature example, Siddiqi (1991)

69) See Chapra (1992)

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent by a Conference of Finance Ministers of Muslim countries held in Jeddah in Dhul Oa'da 1393H (December 1973). The Inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank formally opened on 15 Shawwal 1395H (20 October 1975).

Purpose

The purpose of the Bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of *Shari'ah.*

Functions

The functions of the Bank are to participate in equity capital and grant loans for productive projects and enterprises besides providing financial assistance to member countries in other forms of economic and social development. The Bank is also required to establish and operate special funds for specific purposes including a fund for assistance to Muslim communities in non-member countries, in addition to setting up trust funds.

The Bank is authorized to accept deposits and to raise funds in any other manner. It is also charged with the responsibility of assisting in the promotion of foreign trade, especially in capital goods among member countries, providing technical assistance to member countries, extending training facilities for personnel engaged in development activities and undertaking research for enabling the economic, financial and banking activities in Muslim countries to conform to the *Shari'ah.*

Membership

The present membership of the Bank consists of 55 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of the Islamic Conference and be willing to accept such terms and conditions as may be decided upon by the Board of Governors.

Capital

The authorized capital of the Bank is six billion Islamic Dinars. The value of the Islamic Dinar, which is a unit of account in the Bank, is equivalent to one Special Drawing Right (SDR) of the International Monetary Fund. The subscribed capital of the Bank is 3,654.78 million Islamic Dinars payable in freely convertible currency acceptable to the Bank.

Head Office

The Bank's headquarters is located in Jeddah. Saudi Arabia and it is authorized to establish agencies or branches elsewhere.

Financial Year

The Bank's financial year is the Lunar Hijra year.

Language

The official language of the Bank is Arabic, but English and French are additionally used as working languages.

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