Research Paper
No. 37

PRACTICES AND PERFORMANCE OF

MODARABA COMPANIES

(A Case Study of Pakistan's Experience)

ISLAMIC RESEARCH AND TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK
JEDDAH, SAUDI ARABIA

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

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The Islamic Research and Training Institute was established by the Board of Executive Directors of the Islamic Development Bank (IDB) in 1401H (1981). The Executive Directors thus implemented Resolution No.BG/14-99 which the Board of Governors of 10B adopted at its Third Annual Meeting held on 10 Rabi Thani 1399H (14 March 1979). The Institute became operational in 1403H (1983).

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The purpose of the Institute is to undertake research for enabling the economic, financial and banking activities in Muslim countries to conform to Shari'ah, and to extend training facilities to personnel engaged in economic development activities in the Bank's member countries.

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The functions of the Institute are:

(A) To organize and coordinate basic and applied research with a view to developing models and methods for the application of *Shari'ah in* the field of economics, finance and banking;

(B) To provide for the training and development of professional personnel in Islamic Economics to meet the needs of research and Shari'ah-observing agencies;

(C) To train personnel engaged in development activities in the Bank's member countries;

(D) To establish an information center to collect, systematize and disseminate information in fields related to its activities; and

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The President of the IDB is also the President of the Institute. The IDB's Board of Executive Directors acts as its supreme policy- making body.

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ISLAMIC RESEARCH AND TRAINING INSTITUTE
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TARIQULLAH KHAN
Research Division

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بسم الله الرحمن الرحيم

In the name of Allah, The Beneficent, The Merciful

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FOREWORD

The Islamic Research and Training Institute (IRTI) has the responsibility to undertake research for enabling the economic, financial and banking activities in the Muslim countries to conform to the *Shari'ah.* A number of member countries have already accumulated some experience in the application of the *shari'ah-based* financial instruments. Studies of the practices, performance and challenges of such applications are indeed part of the responsibility assigned to IRTI. The Institute plans to continue undertaking empirical research in the application of the Islamic financing principles. The present study specifically deals with the experience of *Modaraba* Companies operating in Pakistan, in particular, with the application of *mudharabah* certificates in capital markets.

Modaraba Companies are part of the non-banking Islamic financial institutions. In the present study, the institutional framework, evolution, development and profile of the *Modaraba* Companies in Pakistan have been spelled out along with an overview of the market environment for the *mudharabah* certificates. Following that a comparison of the recent position of *Modaraba* as a separate sector has been undertaken with other sectors. In addition, a comparison of the performance of selected *Modaraba* Companies has also been undertaken with the performance of other companies. A number of conclusions and policy implications with reference to the operation of *Modaraba* Companies as non-banking Islamic financial institutions are derived from the study.

This research is hoped to be useful in understanding the opportunities and challenges of participating in the conventional capital markets through *shari'ah-based* financial institutions and instruments. It should be noted that this research has dealt with the case of only one financial instrument, the *mudharabah* certificates. It is hoped that this research may also be instrumental in designing more financial instruments for alleviating the problems of *shari'ah* observing institutions. Moreover, this work may provoke further research dealing with the secondary market position of other Islamic financial instruments.

M. Fahim Khan
Officer-in- Charge, IRTI

I
INTRODUCTION

Non-banking financial institutions are playing increasingly important role in the efficient functioning of modern capital markets. The evolution and development of Islamic banks as depository institutions has also encouraged the development of non-banking Islamic financial institutions including investment funds and insurance companies managed by various Islamic banks. In addition, since 1984, there has been an evolution and significant increase in the activities of *Modaraba* companies (MCos) in Pakistan treated as non-banking Islamic financial institutions by the State Bank of Pakistan (SBP).

These companies constitute an important segment of the Islamic financial system. Useful lessons can be drawn from their experiences and challenges. Since the companies are participants of an emerging dynamic stock market, namely, the Karachi Stock Exchange (KSE), for attracting investments, these companies face tough competition from other market participants. The competitors range from leasing companies (LCos) which are new entrants to the market too, to the relatively experienced and mature market participants, such as, chemical and pharmaceutical firms which are listed in the KSE for many years. Although, the LCos., do not claim to offer an agenda of Islamic financing, these companies however, have emerged in the scene to compete with the MCos., in the renting and trading business, in addition to competing for mobilization of resources as all other firms do.

As direct participants of financial markets, the MCos., are thus, confronted with more serious challenges compared to the Islamic banks. First, the Islamic banks offer a contrasting alternative to interest-based banks - the lines between Islamic and conventional banking are thinly defined. The MCos., do not have this comparative advantage. Since investments in stocks, in general, are permitted from the religious perspective, the MCos., do not offer to their investors, much different investment opportunities compared to common stocks. Second, unlike deposit mobilization by the Islamic banks, the resource mobilization requirements of the MCos., compel them to participate in the capital markets. Third, while contributing to economic development by resource mobilization and allocation, these institutions, compared to Islamic banks are directly and more actively involved in the development of Islamic financial instruments and capital markets. Fourth, the MCos., are providing finance to industry more directly and have been able to establish longer-run relationship between finance and industry, in comparison to Islamic banks. Nevertheless, the activities and functions of the MCos., and Islamic banks are inter-related and supplement each other in spreading the application of Islamic principles of financing.

Whereas, in the existing research on Islamic banking and finance, much attention has been accorded to Islamic banks, investment funds and Islamic insurance companies, MCos., are relatively ignored. The objective of the present paper is to study the evolution, practices and performance of the MCos., as operating under Islamic Republic of Pakistan's *Modaraba* law. Since this exercise can be better undertaken in comparison with similar other institutions, the study also deals with the practices of other non-banking financial institutions, particularly, the LCos., and investment banks.

Section Two deals with the institutional framework, evolution, development and profile of the MCos. Section Three, provides an overall assessment of the KSE, which provides the market environment for the MCos. This Section also reports the recent position of the MCos., as a separate sector in the KSE. Section Four provides comparisons between sectors and individual companies with respect to their acquisition of value overtime. Section Five is an attempt to identify the challenges of the *Modaraba* as a sector as opposed to other market participants. Some suggestions are also proposed, Conclusions and policy implications are discussed in Section Six. As a number of researchers have shown interests in the manner the *Modaraba* business is conducted in Pakistan, the *Modaraba* law, and a sample listing *Prospectus of a Modaraba* are reproduced in the appendices.

II

INSTITUTIONAL SETUP, EVOLUTION AND PROFILE

Mudharabah is an important Islamic financial contract. During the past three decades interests in the contract have renewed. The deposit side of the Islamic banks is largely based on this concept. This experience of the Islamic banks has been instrumental in expanding the scope of *mudharabah.*[1] The experience of the MCos., is yet another important example of the application of *mudharabah* in the contemporary complex market economies. This experience can be expected to encourage the development of sophisticated Islamic financial instruments. The present section and remaining part of the paper deal with the challenges and opportunities of this expectation.

2.1 THE LAW AND REGULATION OF MODARABA COMPANIES

The Law

The establishment and operations of the MCos., are governed by the *Modaraba Companies and Modaraba Floatation and Control Ordinance* 1980[2], and rules, regulations and guidelines issued as follow-up (referred to in the paper as *Modaraba law).* Salient features of the *Modaraba law* are given below.

1. *Modaraba is* defined in the Ordinance as, *"a business in which a person participates with his money and another with his efforts or skill or both his efforts and skill and shall include Unit Trusts and Mutual Funds by whatever name called'.*
2. Under the *Modaraba* law, two different legal entities are established.

   A. *Modaraba Companies (MCos).* MCos., can be formed by any company which is registered under Companies Ordinance 1984 or a private company or public corporate body (established under any law in force and owned or controlled whether directly or through a company or corporation, by the Federal or a Provincial Government) by fulfilling other conditions under the law. MCos., are registered under the Companies Ordinance 1984 as private or public limited companies for multipurpose or specific-purpose operations.. Private MCos., are not registered with the stock exchange.

B. Modarabas. Modarabas are perpetual or temporary Funds floated by the MCos., under the *Modaraba Companies and Modaraba Floatation and Control Ordinance 1980.* Unlike each MCo., each *Modaraba* must be registered with a stock exchange.

3. All *Modarabas* are registered with the Registrar of *Modarabas* by fulfilling certain *shari 'ah* and operational requirements.
4. The *Modaraba* funds are mobilized by issuing *Modaraba* certificates (MCs). The MCs., are *non-voting* shares of common stock in the *Modaraba.*
5. The minimum capital requirement for a multipurpose *Modaraba is Rs.* 7.5 million, and for a single-purpose *Modaraba* it is Rs. 5 million.
6. In both cases, the MCo., has to contribute the initial 10% of the subscribed capital.
7. The MCo., as a manager *(mudharib),* will charge not more than 10% of total annual profits as its remuneration, besides the returns on its capital contribution to the *Modaraba.*
8. The MCo., can issue rights, stock dividends and distribute cash dividends.
9. The MCo., cannot involve in any activity prohibited by the *shari'ah.*
10. Moreover, 75% of the *Modaraba's* operations must be kept in the main line of its business.

The Registrar and Registration of *Modarabas*

As a follow-up on the *Modaraba Companies and Modaraba Floatation and Control Ordinance* 1980, institutional arrangements were made for the establishment of enterprises, floatation of *Modarabas,* religious supervision of the companies' activities, regulation of issuance of certificates, tax coverage and incentives, accounting procedures, arbitration of disputes etc. The above law makes it incumbent for the Federal Government to appoint through separate notification, an office called the

Registrar of *Modarabas.* The Registrar of *Modarabas is* appointed by the Corporate Law Authority (CLA), Government of Pakistan (an official body responsible for implementation of the corporate and allied laws) to regulate and administer the establishment and operation of these enterprise as limited liability companies.[3]

For establishing a MCo., a party applies to the CLA for registration. Before granting registration, the CLA evaluates the application in the framework of the above mentioned law. When a MCo., registered with the CLA, it submits another application for initiating operations - floatation of *Modarabas.* This application is accompanied by a *Prospectus*[4] related to the nature and conduct of business, *Modaraba* certificate indentures etc. To ensure the *shari'ah* conformity of the operations, the entire documents are evaluated by a standing *Religious Supervisory Board (RSB)*[5]. After clearance from this board, the company applies to the Controller of Capital Issues and Stock Exchange for floatation of the *Modarabas.* Once operational, periodic inspections are undertaken by the RSB, and chartered cost and management accountants appointed by the CLA.

No company can become operational without a registration with the Registrar of *Modarabas.* An applicant for registration as a MCo., must itself be a registered company under various concerned laws of the Islamic Republic of Pakistan. The company, must have at least 5-7 million Rs. paid-up capital for the purpose of the *Modaraba* business. Before granting registration, the Registrar has also to make sure about the integrity of the promoters of the *Modaraba,* the nature of business to be undertaken in relation to the *shari'ah,* and compliance with other relevant laws. All the required details have to be presented in the Prospectus of the applicant. Following are the salient features of the guidelines of Registrar *Modarabas.*

1. Sponsors must have a certified net worth (and declared to the tax officials), not less than the amount subscribed by them personally.
2. The sponsors must have clean record with tax departments, banks and other regulatory organizations.

3. The proposed Chief Executive Officer (CEO) of a MCo., must be of clean background. Once appointed, a CEO cannot be removed without the consent of the Registrar *Modarabas.*
4. No more than 50% of sponsoring Directors can be from the same family.
5. Experienced sponsors are preferred for the allotment of registration.
6. A sponsorship shall not be transferred at least for two years.
7. All companies will appoint Chartered Accountants.
8. Registration for subsequent *Modaraba* floatation can only be granted upon receiving reports of previous operations. If reports of three years are not available, registration will not be granted.
9. No business activities will be repugnant to the *shari'ah.* This will be verified by the RSB.
10. The MCo., will agree to the regular administrative, financial and religious inspections and audits of the *Registrar Modarabas* and
11. Once the Prospectus is approved by the *Registrar Modarabas,* only then the registered MCo., shall approach the Controller of Capital Issues and the stock exchange for floatation of the *Modaraba* certificates.

Tax Rates

Initially, those *Modarabas,* which were distributing 90% of their profits as dividends were exempted from corporate income tax. At the present, for initial three years all companies are tax exempt. For the subsequent two years each company is subject to 12.5% tax on corporate income. Thereafter, each company is subject to 25% corporate income tax like all other companies. Since June 1995, the government has also imposed a 15% tax on stock dividends.

State Bank Regulations

The SBP has no specific regulations for the MCos. These companies are treated by the SBP as non-banking financial institutions. The instructions of the SBP for floatation of *Modarabas* by such institutions are given in the *Prudential Regulations for Non-banking Financial*

Institutions. Following are the salient features of these regulations which also affect the MCos.

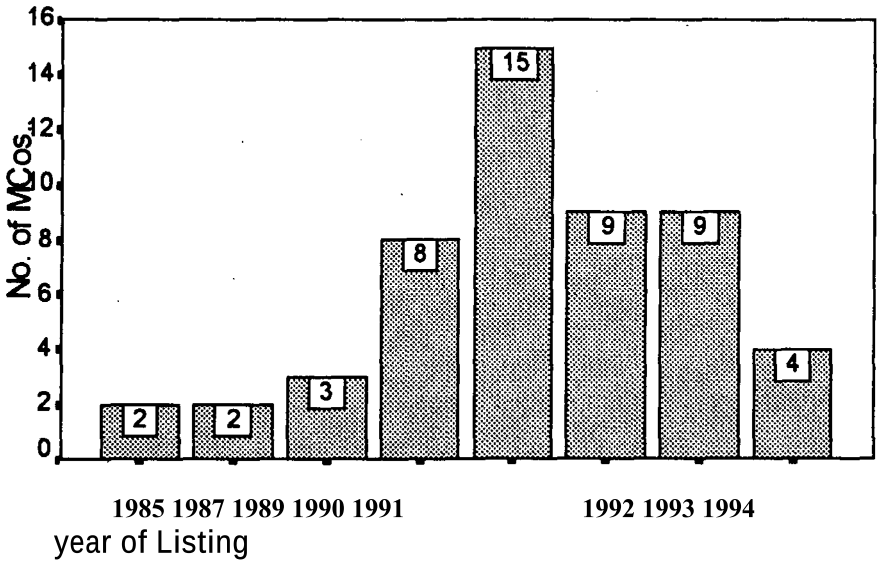
1. Each *Modaraba* will establish with the SBP a reserve fund equivalent to its own paid up capital. This reserve fund will be established by annual contribution of at least 20% of the after tax profits of each *Modaraba* floated. Once the reserve fund equals the paid-up capital, the annual contribution will be decreased to 5% of after tax profits. Stock dividend is considered as an appropriation for this purpose.
2. At least 15% of the liabilities of the *Modaraba* must be invested in the National Investment Trust Certificates (NIT Units) or in securities of public corporations.
3. At least 70% of the *Modaraba* 's assets to be kept in its principal line of business.
4. For initial two years, the debt/equity proportion of the *Modaraba will* be 1:7, thereafter, it can be 1:10 and may be further changed with the consent of the concerned regulatory authorities.
5. A *Modaraba* will not be entitled for any financial assistance if its debt/equity ratio remains below 60:40 on long-term basis. This level of debt/equity ratio must be maintained by all energy sector *Modarabas.*
6. Current assets/current liabilities ratio will have to be maintained at 1:1 of the *Modaraba's* equity.
7. A single business group cannot be financed by more than 20% of the *Modaraba's* equity, and
8. The instructions also regulate the *Modarabas'* business practices with its Directors and principal share holders.

During 1991-92, Pakistan experienced large scale financial scandal involving cooperative banks and finance companies. These institutions were classified by the SBP as non-banking financial institutions. It is widely believed that the negative image of these cases of failures has been large as far the confidence of investors in the *Modaraba* sector is concerned. After this scam, the SBP, CLA and Registrar of *Modarabas* have also increased their regulatory supervision. These regulations are often alleged to be too restrictive by the *Modarabas.*

2.2 PROFILE OF COMPANIES[6]

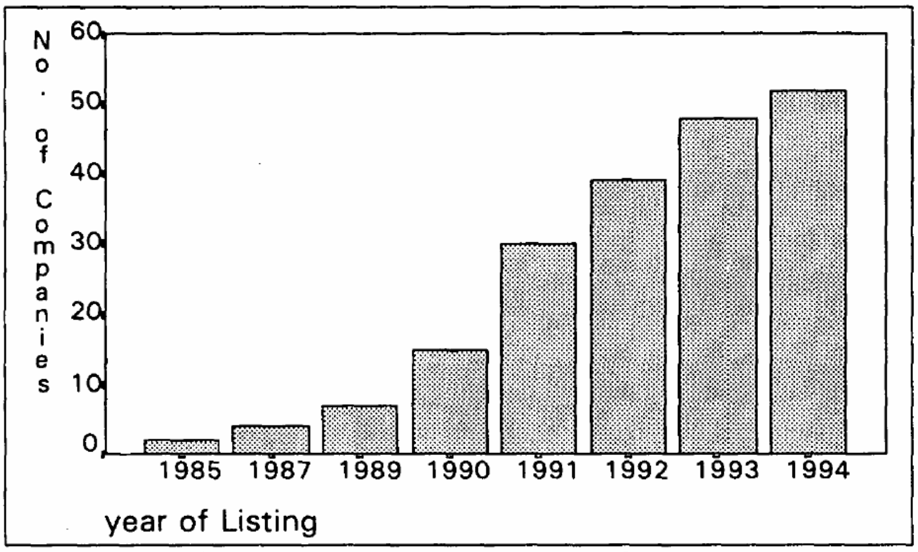
The *Modaraba* legislation was complete by 1984. The first MCo., was authorized in 1984 and the *Modaraba* was floated in 1985. Charts 1-4, provide the yearly increase in the number of MCos., and their paid-up capital. From charts - 1 and 2, it can be seen that the real increase in the number of listed companies came during 1990-93, highest number, 15 companies listed during 1991. By the end of June 1994, there were 52 *Modarabas* listed in the stock markets of the country, with a total paid-up capital of about Rs. 8 billions.

CHART 1



Yearly Listing of *Modaraba* Companies

CHART 2



Cumulative Yearly Listing of *Modaraba* Companies

CHART 3

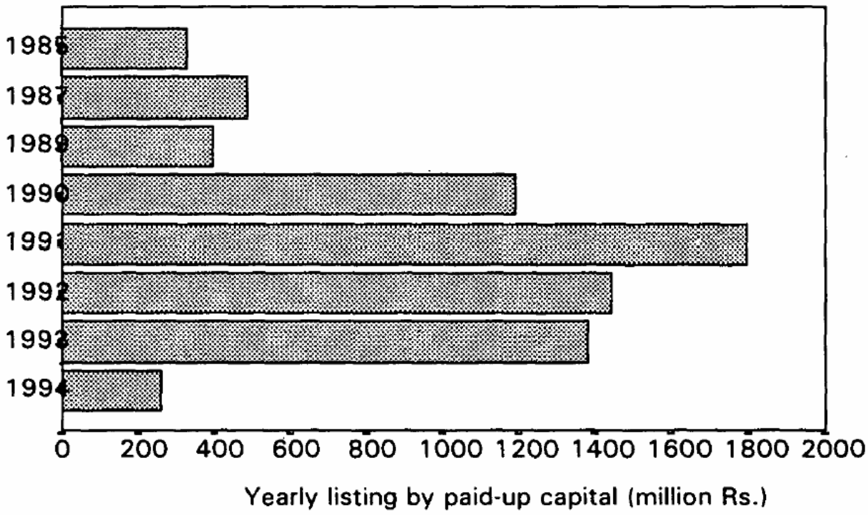
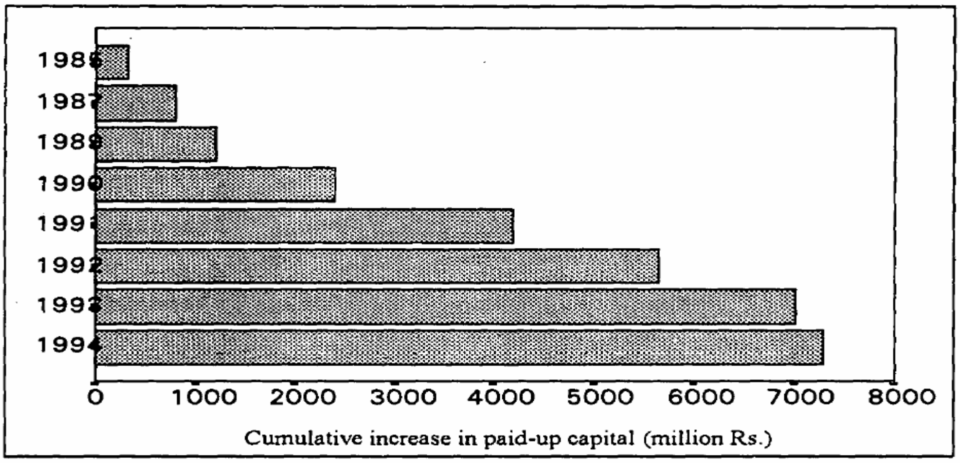


CHART 4



Similarly, from charts 3 and 4, it can be seen that by 1989, the total paid-up capital of about Rs. 1.2 billion was listed in the *Modaraba* sector. Another Rs. 1.2 billion was added during 1990, a record level of Rs. 1.8 billion was added during 1991. By the end of June 1994, the total cumulative paid-up capital listed in the *Modaraba* sector reached to about Rs. 8 billion, which was 9.4% of total paid-up capital listed in the KSE. For the 1985-95 period, the average annual growth rate of the listed capital in the *Modaraba* sector has remained about 50%.

Ownership Structure

The companies are registered as limited liabilities. Most *Modarabas* are floated by sponsors in the group of 4-8 persons. This is one of the important differences of the MCos., from the traditional concept of a *mudharabah* enterprise in which the *mudharib is* a single person. However, considering the *mudharib* as a legal entity, this difference ceases to exist. The 5-6 group of sponsors is most common.

TABLE 1

***MODARABA* CERTIFICATE HOLDERS BY CATEGORY IN % BY END OF JUNE 1992**

	Indivi-duals	Investment companies	Insurance companies	Joint stock compan-ies	Financial institu-tions	*Modaraba* companies	others
Average of 9 companies for 1990	61.22	4.96	3.52	10.35	11.52	8.21	.22
Average of same 9 com-panies for 1991	53.91	7.15	4.09	9.74	16.15	8.80	.16
Average of 8 new com-panies for 1991	55.15	4.09	2.23	4.67	18.54	4.32	10.99

Source: Derived from CLA (1992)

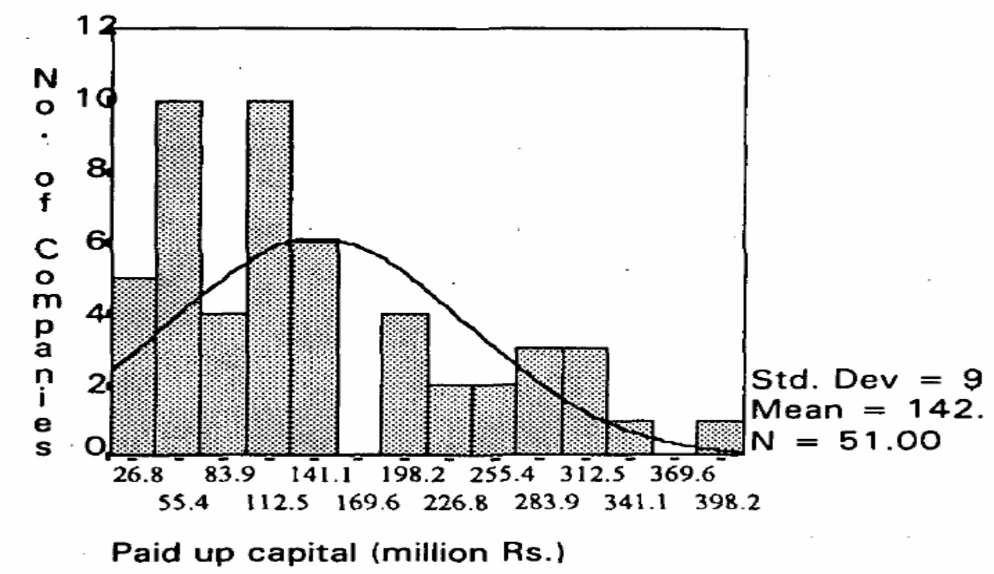
The companies raise funds from the market by issuing the tradable MCs. Table-1, provides information about the holders of the certificates of some companies. An important conclusion to be derived from this table is that the companies have been able to reach the individual investors, as a large part of the certificates are held by individuals. The second largest group of the certificate holders are the financial institutions.

Size

The legislation allows *Modarabas* to be as small as worth Rs. 5 million; *a Modaraba* can be floated with a Rs. 5 million paid-up capital. However, MCos., are not necessarily small companies compared to the size of an average company in the KSE. Frequency distribution of the *Modarabas* in terms of the size of their paid-up capital is provided in chart-5. Out of the 52 companies, 35 companies have a total paid-up capital of less than 150 million Rs. In fact, 25 companies are listed with a paid-up capital less than 100 million Rs. (about 3 million US dollars). Ten companies have paid-up capital less than 50 million Rs. (about 1.5 million US dollars). Two companies are listed with capital as small as 25 million

Rs. Only 16 companies have paid-up capital above the KSE average. The largest two companies have a paid-up capital of Rs. 400 million each.

CHART 5



Sources of Funds

Information on the debt-equity position of 20 MCos., is available for 1993 and 1994 and is given in table-5. Out of these, 12 companies are 100% equity-based. Only one company has over 50% debt in its capital (this company happens to be the oldest one), but it reduced its debt/equity ratio from 1.17:1 in 1993 to 1.13:1 in 1994. The remaining MCos., have very little debt in their capital structure.

The sources of debt in the capital are installment purchase, lease contract deposits, customer security deposits and long-term lease finance. The sources of equity include *musharakah* funds of the sponsors and *Modaraba* funds of the certificate holders, capital reserve, general reserve and un-appropriated profits.[7]

Source of Income

TABLE 2

SOURCE OF CURRENT INCOME

	Sources	1990 Average for 9 companies	1991 Average for the same 9 companies	1991 Average for 8 new companies	1991 Average for 17 companies
SOURCES OF CURRENT INCOME %	Leasing	75.92	80.65	.79	70.09
	Investment	.57	.25	.79	.31
	Trade Credit	18.72	14.04	51.31	18.97
	PLS A/C	.34	.33	.88	.40
		2.42	1.60	27.6	5.05
	Others	2.03	3.13	18.63	3.18

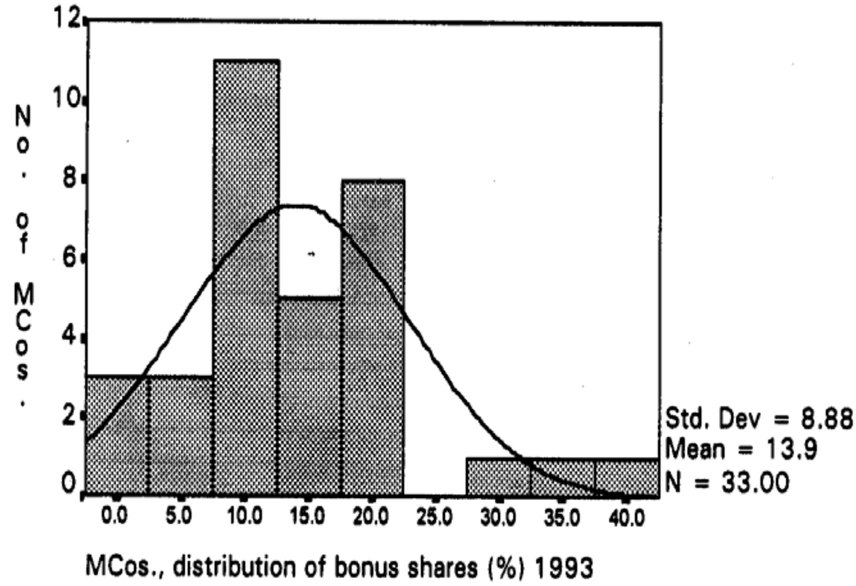
Source: Derived from CLA (1992).

Some information about the sources of current income for some companies is given in table-2. Rentals are the dominant source of the operating income of the companies. This implies that most funds are engaged in equipment and assets. Trade finance in the form of mark-up is also significant source of the operating income of the companies.

Dividends

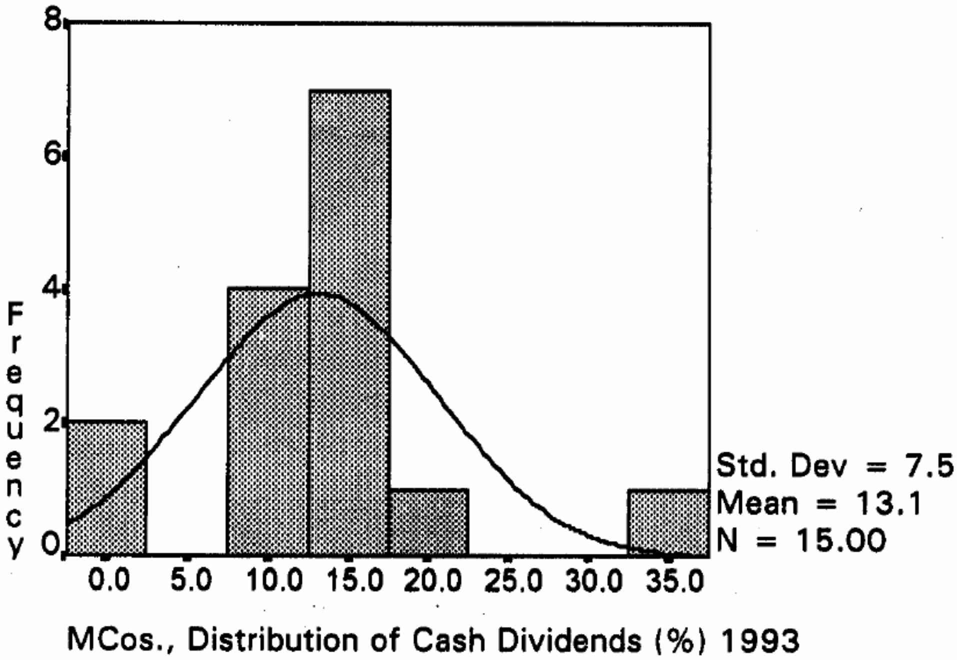
According to the *Modaraba* law, dividends can be paid either in cash, or in the form of stocks. Table-5, contains information about the number of companies which paid cash and stock dividends during 1993. This information is summarized in charts 6 and 7, respectively, for stock and cash dividends. As can be seen from these charts, 33 companies paid stock dividends at an average rate of 14%, the highest being 40% and the lowest 4%, 27 companies paid more than 10% stock bonus and 8 companies paid 20% stock bonus.

CHART 6



As compared to 33 companies which paid stock dividends, only 15 companies paid cash dividends, the average dividend being 13%, the highest 32% and lowest 3%. Discrepancies in tax benefits are important reasons for such an over reliance on stock dividends. Since, fiscal year 1995, a 15% tax has been imposed on stock dividends, this is expected to change the composition of total dividends paid. The over-reliance on stock dividends may also be due to shortage of cash. With the evolution of financial instruments compatible with the shari'ah, and resultant improvement in the liquidity position of the companies, it can be expected that in the future the reliance on stock dividends will be reduced.

CHART 7



Ten companies paid both stock dividends as well as cash dividends. The highest cash dividend (32.5%) paying company also paid 10% bonus shares, paying highest total dividends. The highest stock dividend paying company did not pay cask dividend.

Rate of Return on Equity (ROE)

Information about ROE is available for 20 companies for 1993 and 1994 (see, table-3). The average ROE for the 20 companies in 1993 was 17.44% which reduced to 13.6% during 1994. Compared to 2 companies ROE below 10% during 1993, in 1994, the ROE of 8 companies fell below companies registered an ROE above 15%. Compared to these, the average ROE for most of the 20 mutual funds of the Investment Corporation of Pakistan, for 1992 was over 25%.

CHART 8

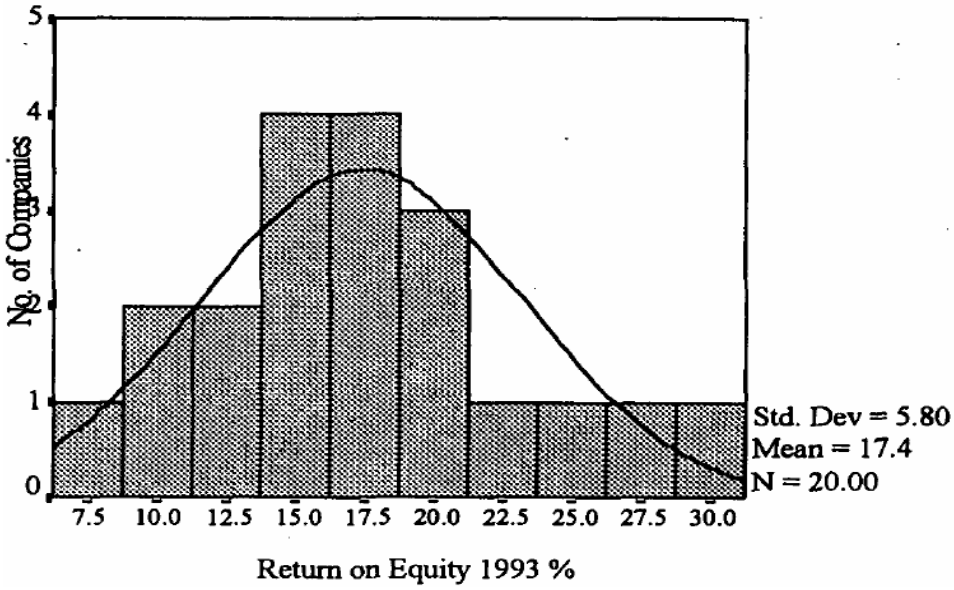


TABLE 3

FREQUENCY DISTRIBUTION OF 20 *MODARABA* COMPANIES AND ICP MUTUAL FUNDS IN TERMS OF ROE

% ROE	*Modaraba* Companies in 1993	*Modaraba* Companies in 1994	20 Mutual Funds in 1992 randomly selected out of 28
less than 10	2	8	nil
10-15	6	5	nil
15-20	6	3	4
20-25	4	1	3
greater than 25	2	2	13

Source: Derived from: a) Table 5 and b) KSE, Company Analysis

Earning Per Share (EPS)

The EPS, calculated as total net income of the company divided by the number of its shares of common stock outstanding, gives a measurement of how investors are benefiting in terms of their earning per each share held by them. If a company has 10 million outstanding shares and earns Rs. 20 million net profit, its EPS is Rs. 2. Table-4 shows that during 1992, per share, investors in the ICP Mutual Funds earned in average over Rs. 40, while investors in the *20 Modarabas* earned an average EPS of Rs. 1.93, which jumped to Rs. 6.38, in 1994. This jump is due to an unusual, Rs. 93 EPS, realized by one company, but the number of MCos., whose EPS declined increased in 1994.

TABLE 4

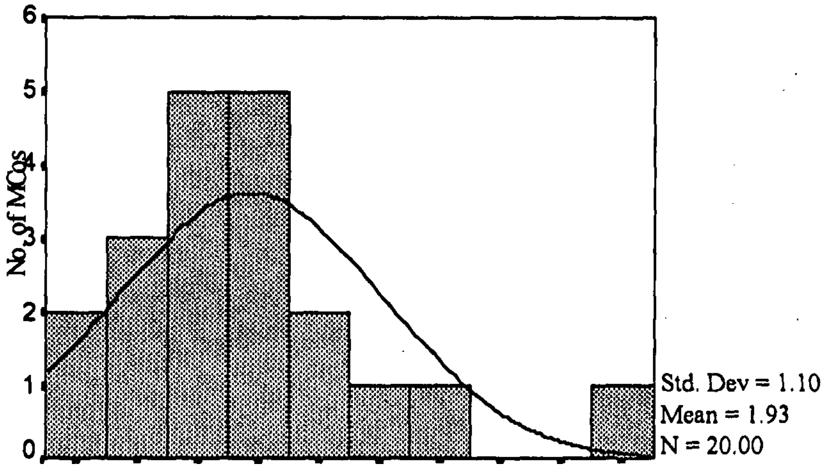
FREQUENCY DISTRIBUTION OF *20 MODARABA* COMPANIES AND ICP MUTUAL FUNDS IN TERMS OF EPS RS.

Frequency of Earning Per Share Rs.	*Modaraba* Companies in 1993	*Modaraba* Companies in 1994	20 Mutual Funds 1992 randomly selected out of 28
less than 1	3	3	nil
1 to1.50	2	9	nil
1.50 to 2	7	1	2
2 to 2.50	6	1	3
greater than 2.5	2	6	15

Source: Derived from: a) Table 5 and b) KSE, Company Analysis

The EPS is a crucial indicator of changes in the stock-holders' wealth over time. Given other considerations, higher EPS is better compared to a lower one, but a number of factors must be watched over a *period* of time to have a meaningful comparison between the EPS of various companies. Many factors, including time value of money for investors, relative risk-return-trade-off, leverage and the changes in stock prices, capital gains effect the meaningfulness of EPS overtime. EPS also changes the distribution of wealth between old and new stock-holders as the proportionate growth in the net profits may be lesser compared to the proportionate new issues which could finance the growth opportunities.

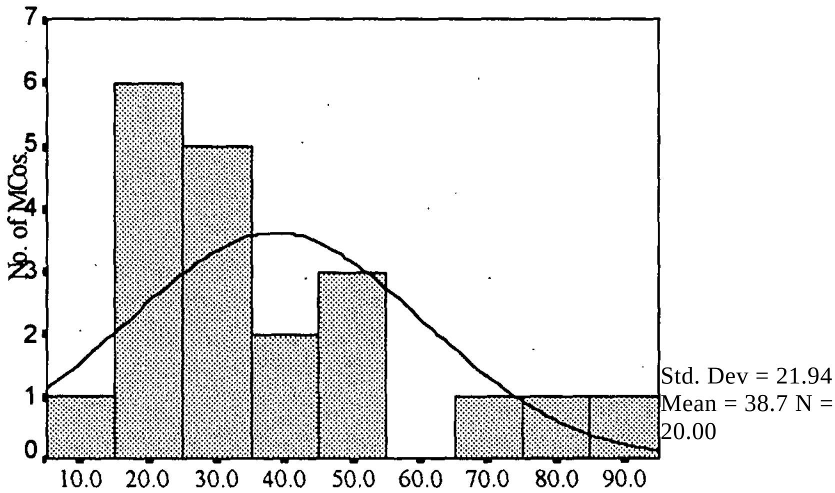
CHART 9



.50 1.00 1.50 2.00 2.50 3.00 3.50 4.00 4.50 5.00

Earning per share 1993 Rs.

CHART 10



Profit after tax 1993 (million Rs.)

Market Valuation Ratio (MVR)

MVR, market capitalization/paid-up capital, is another crucial indicator of the performance of a listed company. MVR depends on the volume of trade in a particular stock. Given capitalization/paid-up capital data of table-5, MVR for 20 MCos., during April 1995, is calculated and is given in chart-11, It can be seen that the mean MVR for the MCos., is even lesser than one point. This information may be compared with the mean value of MVR for the KSE, which was 5 points on June 30, 1994. The MVR for the *Modarabas* has declined further during the rest of 1995.

CHART 11

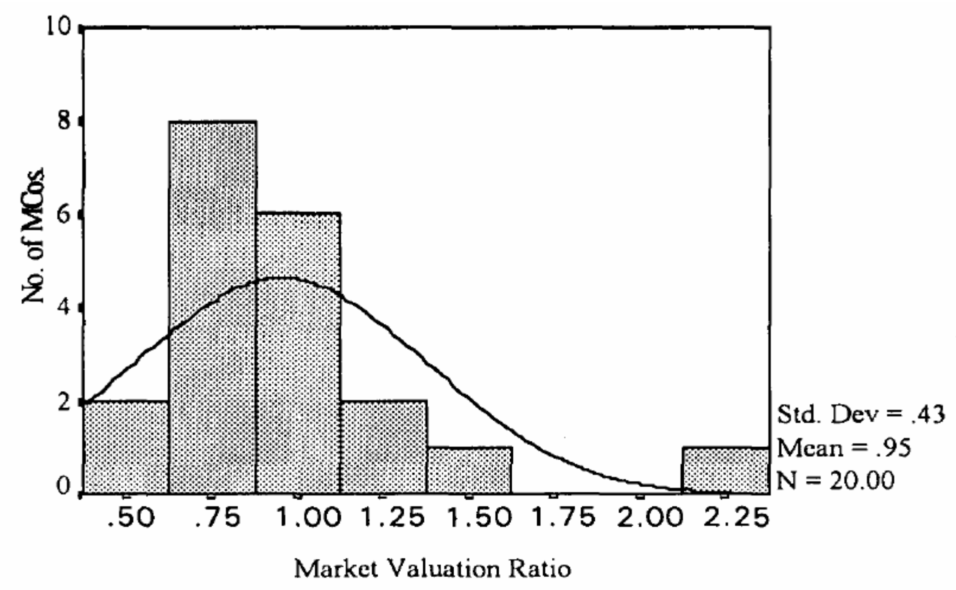


TABLE 5
PROFILE OF *MODARABA* COMPANIES

Name of MCo.	Year of Listing	Paid up capital Rs.(M)	Capitalization Rs. (M) April 1995	% Stock bonus in 1993	D/E Ratio 1993	D/E Ratio 1994
Al-Ata Lease	1992	50,00	.	10,50	.	.
Al-Zameen Lease	1992	110,00	.	,00	.	.
Al-Noor-I	1992	210,00	152,00	5,00	,00	,00
Allied Bank I	1993	350,00	245,00	1,60	,00	,00
Asset Lease	1993	39,69	.	.	.	.
BRR Capital I	1985	202,82	294,00	.	1,17	1,13
BRR II	1990	150,00	109,00	.	,00	,00
Confidence I	1991	55,00	.	10,00	.	.
Constellation I	1991	64,63	.	17,50	.	.
Crescent I	1991	158,03	158,00	7,50	,15	,18
Custodian I	1994	30,00	.	.	.	.
DGM I	1992	50,00	.	.	.	.
DR Asset	1993	39,69	.	.	.	.
Elite Capital	1992	113,40	.	5,00	.	.
Equity Int	1993	150,00	96,00	.	,00	,00
Equity M I	1992	262,20	197,00	.	,00	,00
F.B *Modaraba*	1989	45,70	.	,00	.	.
Fidelity M I	1992	208,80	193,00	20,00	,00	,00
Financial Link	1994	100,00	.	.	.	.
Guardian Lease	1994	100,00	.	.	.	.
General Lease I	1993	56,25	.	12,50	.	.
Grindlays M	1987	346,50	820,00	10,00	,67	,49
Habib Bank I	1991	397,07	258,00	15,00	,00	,00
Habib M I	1985	252,00	242,00	20,00	,12	,09
Hajvery M I	1991	205,32	123,00	18,00	,00	,00
Ibrahim M I	1993	116,00	104,00	16,00	,00	,00
Imroz M I	1994	30,00	.	.	.	.
Industrial C M	1991	86,25	.	.	.	.
Inter Fund M I	1991	67,85	.	20,00	.	.
LTV Capital	1989	400,00	548,00	.	,47	,18
M Al Mal	1987	182,57	173,00	28,00	,27	,20
M Al Tijara	1991	66,00	.	10,00	.	.
Mehran M I	1990	83,16	.	20,00	.	.
National M I	1989	52,99	.	.	.	.
Pak M I	1991	110,00	.	10,00	.	.
Premier M I	1991	27,50	.	.	.	.
Professional M I	1991	77,67	.	15,30	.	.
Providence M I	1991	63,13	.	18,00	.	.
Prudential M I	1990	293,31	.	12,00	.	.
Prudential M II	1990	193,05	.	10,00	.	.
Prudential M III	1991	222,60	.	5,00	.	.
Punjab M I	1993	270,00	284,00	35,00	,00	,00
Sanaullah M I	1990	116,88	.	.	.	.
Schon M	1992	234,00	103,00	17,00	,00	,00
Tawakal M I	1990	258,75	.	20,00	.	.
Tri Star M I	1990	96,80	.	10,00	.	.

Tri Star M I	1990	15,00	.	.	.	.	.
Tri Star M II	1993	10,00	.	.	.	.	.
Trust M	1992	.	28,60	16,80	5,21	2,82	78,10
UDL M	1991	.	9,50	27,80	1,09	3,98	18,50
Unicap M	1991		18,10	10,90	2,00	1,35	24,80
Mean		13,10	17,44	13,59	1,93	6,38	38,71
N		15	20	19	20	20	20

(Cont'd)

Name of MCo.	Year of Listing	Paid up capital Rs.(M)	Capitalization Rs. (M) April 1995	% Stock bonus in 1993	D/E Ratio 1993	D/E Ratio 1994
Tri Star M II	1993	110,00	.	.	.	.
Trust M	1992	273,00	369,00	40,00	,67	,02
UDL M	1991	249,38	212,00	11,00	,11	,15
Unicap M	1991	136,40	89,00	10,00	,00	,00
Unity M	1993	300,00	.	.	.	.
Sum		7864,39	4769,00	459,90	3,63	2,44
Mean		154,20	238,45	13,94	,18	,12

Name of MCo	Year of Listing	% Cash Dividend 1993	% ROE 1993	% ROE 1994	EPS Rs. 1993	EPS Rs. 1994	PAT 1993 Rs. (M)	PAT 1994 Rs. (M)
Al-Noor-I	1992	15,00	20,70	8,80	2,22	,92	44,40	19,40
Allied Bank I	1993	.	14,30	9,50	1,67	1,04	50,10	36,50
Asset Lease	1993	.	.	.	.	.	.	.
BRR Capital I	1985	17,50	22,00	11,20	,26	1,46	51,90	29,60
BRR II	1990	15,00	18,50	1,61	2,04	2,05	30,60	30,80
Confidence I	1991	32,50	.	.	.	.	.	.
Crescent I	1991	15,00	21,10	21,70	2,27	2,78	27,20	35,90
DGM I	1992	12,50	.	.	.	.	.	.
Equity Int	1993	.	8,30	.	,96	1,47	14,40	21,40
Equity M I	1992	15,00	13,60	13,30	1,59	1,75	36,20	40,00
F.B *Modaraba*	1989	,00	.	.	.	.	.	.
Fidelity M I	1992	.	16,70	18,20	2,00	2,66	23,30	31,00
Grindlays M	1987	17,00	19,10	7,90	3,00	1,22	94,60	42,20
Habib Bank I	1991	.	13,40	8,50	1,55	93,00	53,60	36,90
Habib M I	1985	.	17,30	8,20	1,06	,46	22,20	11,50
Hajvery M I	1991	.	15,50	9,60	1,86	1,26	32,40	21,90
Ibrahim M I	1993	.	14,00	12,20	1,63	2,77	16,30	32,20
Inter Fund M I	1991	10,00	.	.	.	.	.	.
LTV Capital	1989	.	10,40	44,00	,44	3,33	17,70	133,20
M Al Mal	1987	.	24,00	10,90	2,61	1,23	34,50	17,60
Punjab M I	1993	.	29,90	12,90	3,50	1,48	70,00	40,00
Sanaullah M I	1990	12,00	.	.	.	.	.	.
Schon M	1992	.	13,80	4,20	1,67	,53	33,40	10,70
Tri Star M I	1990	15,00	.	.	.	.	.	.
Tri Star M II	1993	10,00	.	.	.	.	.	.
Trust M	1992	.	28,60	16,80	5,21	2,82	78,10	55,00
UDL M	1991	.	9,50	27,80	1,09	3,98	18,50	75,10
Unicap M	1991		18,10	10,90	2,00	1,35	24,80	16,80
Mean		13,10	17,44	13,59	1,93	6,38	38,71	36,89
N		15	20	19	20	20	20	20

Notes: (.) implies complete information missing.

Abbreviations: MI, First Modaraba; MII, Second Modaraba; VIII, Third Modaraba; DIE, Debt/Equity; ROE, Return on Equity; EPS, Earnings Per Share; PAT, Profits after Tax. Sources:Compiled from: a) Various Issues of *Pakistan And Gulf Economist*, Karachi. b) Annual Report of Corporate Law Authority, Islamabad. *c) Bulletin State Bank of Pakistan,* Karachi, various issues, and d) Karachi Stock Exchange, *Report on Companies.*

NOTES

[1] See, Kalif and Khan (1992) on how the deposit side of Islamic banks has actually expanded the concept.

[2] This law was introduced on June 26, 1980, (for text, see appendix-1). Evolution of an alternative system to interest has remained under consideration of policy makers in Pakistan for a long time. The 1973 constitution calls for a complete elimination of *riba* from the economy. However, paradoxically, pronounced efforts in this regard were made only during 1977-85, the period, when the constitution remained suspended. The extreme attitude of presenting Islam and the constitution as competing goals has unfortunately cost the country her political and constitutional stability and socio-economic welfare. Even Pakistan's experience with conversion of its banking and financial system during the 1977-85 period into an Islamic one may well be seen skeptically. As far the operations of commercial banks, national development financing institutions, and public sector resource mobilization is concerned, such a skepticism is not unfounded (one may refer to IPS 1994, for a general evaluation of this exercise). However, there are also some examples of positive institutional changes for the operation of an interest-free Islamic financing system. Scholars and policy makers agree that the approach to be pursued to replace *riba* with some Islamic alternatives, has to be gradualist and two pronged. First, an attempt is needed to familiarize the public with the broader Islamic alternatives. Secondly, a legal framework needs to be ensured to smoothen the process of the supply of the Islamic alternatives to forth come. With respect to both these policy objectives some successes have been achieved in Pakistan.

[3] Since 1990, the Corporate Law Authority has started publishing annual reports on the companies. So far, two reports have been released (1990-91 and 1991-92). Some information in this paper has been drawn from these reports.

4 For a sample prospectus, see, appendix-2.

[5] The Board consists of three members, one of them nominated as chairman must be a person to be qualified as a Judge of the Supreme Court of the country. The two other members should be prominent religious scholars.

6 All charts included in this section are based on Table-5.

7 See CLA (1992).

III

THE MARKET ENVIRONMENT

For most companies the choice to list themselves in stock exchanges comes after some operational experience. Except for mutual funds, initiation of business activities with listing in a stock market is a rare phenomenon. Despite operational differences between MCos., and mutual funds regarding *initiating* business by Iisting in a stock market is a rare phenomenon. Despite operational differences between MCos., and

Mutual funds regarding initiating business by listing n a stock market, the case of Modarabas is similar to mutual funds. It is extremely difficult for the MCos., to initiate business by listing in a stock market, rather than to initiate operations and list latter. The market environment for the MCos., is briefly provided in this section with an overview of the KSE along with the overall status of MCos., in the market during 1994.

3.1. STOCK MARKETS IN PAKISTAN

The operational pattern of MCos., indicates that the stock market is crucial for their existence. Pakistan has three stock exchanges: A matured one in Karachi, and two novices, one each in Lahore and Islamabad. Most Modarabas are listed in all the three markets, but KSE is the hub of their business. The historical development of the KSE is summarized in chart – 12 depicting the number of companies, chart-13 reflecting the paid-up capital and market capitalization and finally chart-14 showing the pattern of MVR1>

Established in 1950, the KSE in now a matured market. In 1950, 15 companies were listed in the KSE with a total paid-up capital of Rs. 117 million. By April 1995, about 700 companies were listed in the market with a total paid-up capital of about Rs. 87 billion. It can safely be expected that the number of listed companies will increase to over 780 during the next five years. The forecast for this trend is given in chart-12.

Chart-12. Number of Companies Listed in the KSE

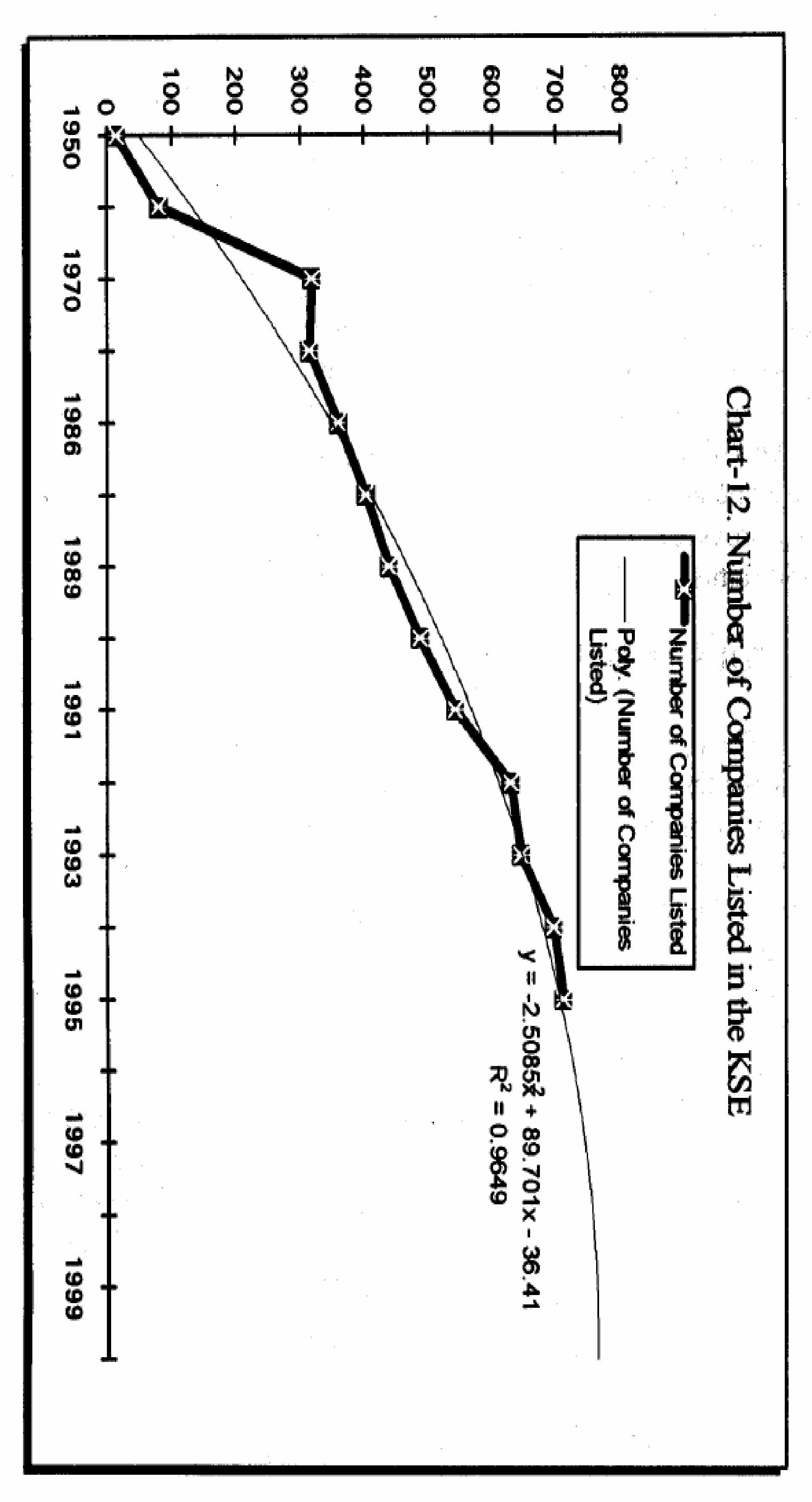
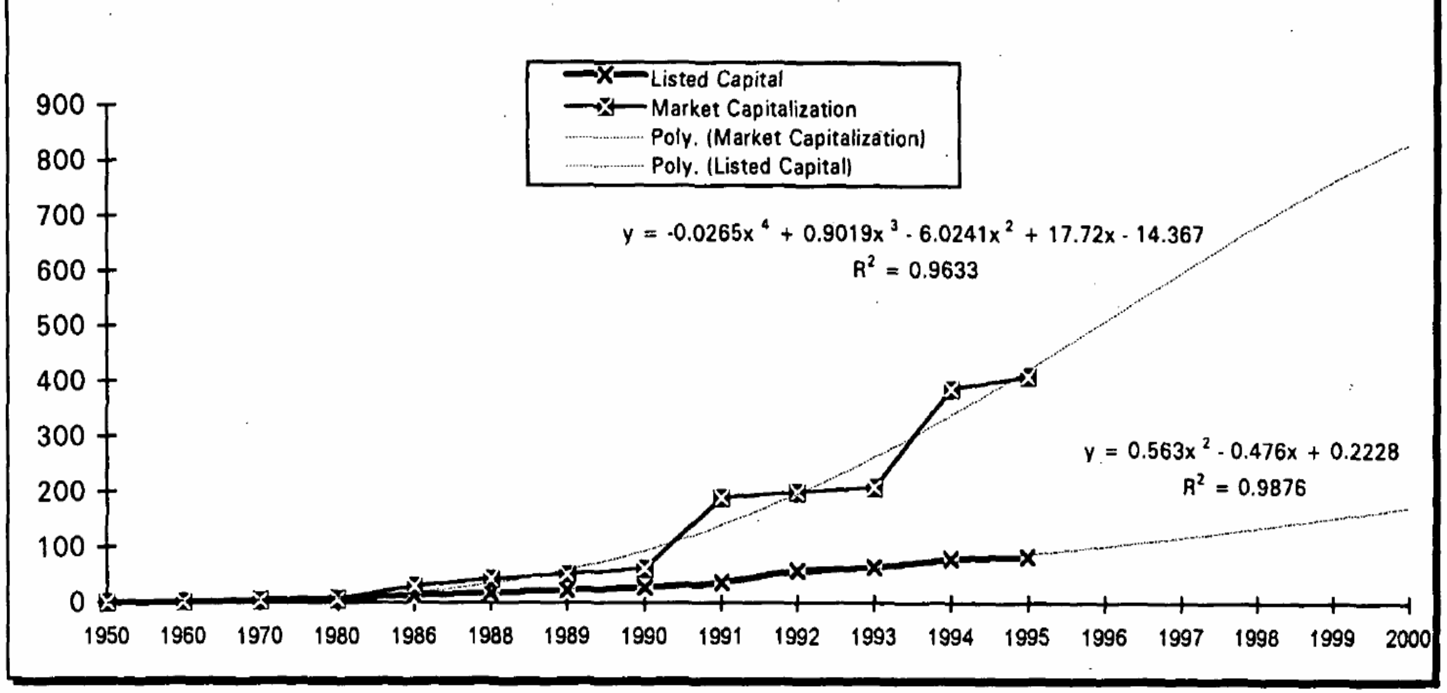


Chart-13. Size of the KSE in billion Rupees

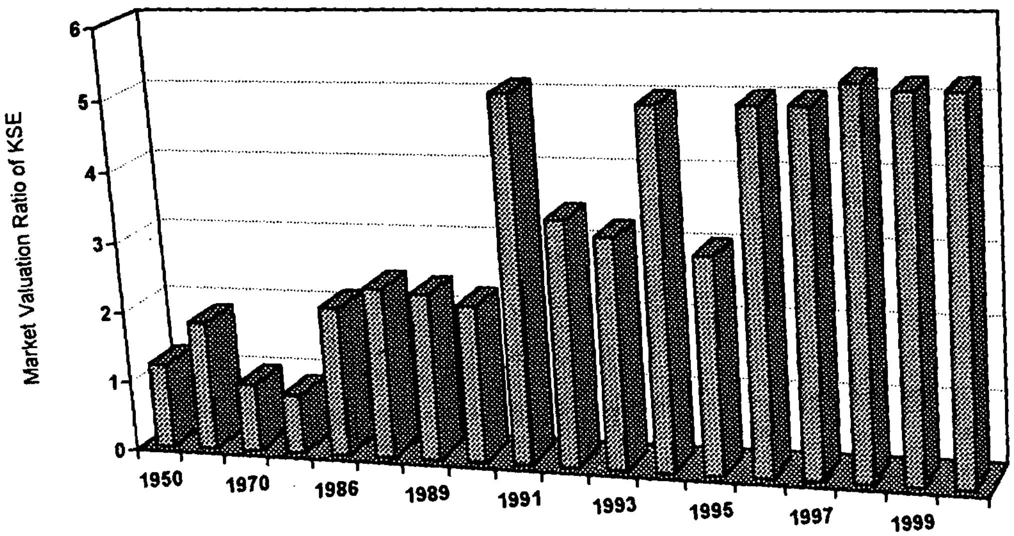


It is interesting to note that during the 1970-80 period, the market remained almost stagnant at around 300 companies (actual figures, 300 in 1970, 314 in 1980). During this period, the total paid-up capital of the listed companies increased to Rs. 7.5 billion from Rs. 4.4 billion in 1970. However, the market remained stagnant, as the capitalization declined to lower levels, even compared to the paid-up capital.

Business activities of the market accelerated after 1980 (see, charts 12 and 13). By 1986, the number of listed companies increased to 360, involving a paid-up capital of Rs. 14.4 billion. Actual acceleration of the market is obvious from the five-fold- increase in the market capitalization to Rs. 30.3 billion in 1986 from Rs. 6.4 billion in 1980. Since then, the KSE continuously gained strength. While growth in the number of listed companies and paid-up capital has steadily increased ever since, during 1990-91, there was an upsurge in the trading activity and market capitalization increasing from Rs. 62 billion in 1990 to Rs. 190 billion in 1991. Since then, the increase in market capitalization has again been steady, whereas, relatively, the paid-up capital has increased at a faster pace.

On the basis of the past 45 years operations and expansion of the KSE, some forecasts can also be made about the future status of the KSE (see, chart 12). By the year 2000, about 780 companies will be listed in the KSE. The total paid-up capital of these companies is estimated to reach Rs. 170 billion. As the R^2 is significantly high, (.988), this estimate could be considered as a good approximation. On the other hand, the market capitalization is estimated to reach over 800 billion Rs. Again, given the .96 value for the R^2 this can be considered another reasonable estimate.

Chart-14: Valuation Ratio of the Market
(Market Capitalization/Listed Capital)



The MVR considerably improved in 1960 over 1950, but substantially declined during the seventies (see, chart-14), During the 1986-90 period, the MVR remained around 2 points. The up-surge in the market activity pulled the ratio to 5 points in 1991, again declining to around 3 points during 1992-93. There has been an improvement in the market activity during 1994. But, due to policy differences between the government and the business community, the market activity declined to record lows during the early half of 1995 pushing the MVR ratio to below 3 points.

However, the market activity is expected to take momentum. Based on the 45 years activity of the KSE, our projected mean MVR for the future five years is around 5 points. This scenario is based on expectations that an understanding between the business community and the government will be reached, political stability, particularly in Karachi will be achieved, privatization and macro-economic improvement expected from foreign investment-based energy sector led growth will be realized by time of budget for fiscal year 1996. For the period 1997-2000, we expect the MVR to 'remain over 6 points on an average which will prove instrumental in covering the losses during 1995-96.

3.2 BASIS OF COMPETITION

Under the law, MCos., can operate as mutual funds. However, in practice, almost all MCos., are operating in the leasing and installment trade business. Thus, as far asset management is concerned, MCos., are practically competing with the LCos. Moreover, commercial banks have also entered the leasing business. Banks are also involved in the installment trade as an Islamic mode of finance. There is, however, a difference between the installment trade business of banks and *Modarabas:* banks only finance trade, and *Modarabas* involve in trade directly.

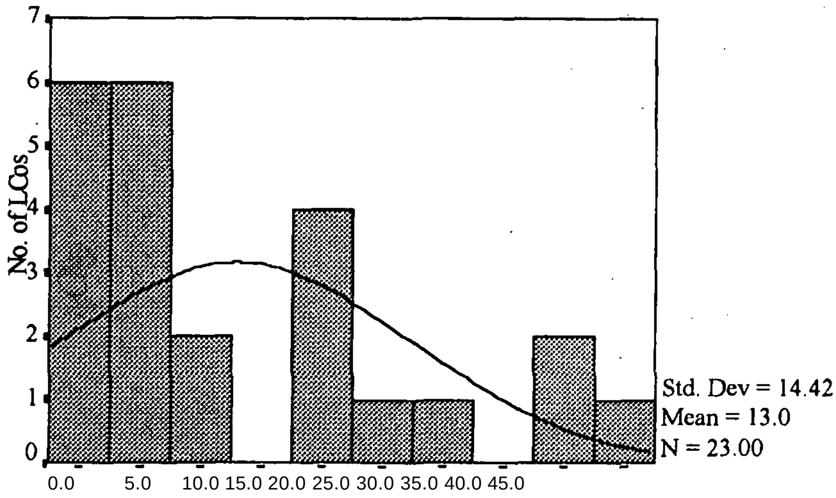
Like *Modarabas,* leasing is a new and fast growing sector in Pakistan. Most *Modarabas* are in fact LCos., but for their preference for *shari'ah,* have registered as MCos. Except for this choice of the legal framework, and requirement that the paid-up capital of a leasing company must be at least Rs. 100 million, as compared to Rs. 5-7 million for *Modarabas, LCos.,.* and *Modarabas* are treated similarly by the SBP, Controller of Capital Issues and Stock Market as non-banking financial institutions. Reform in corporate income tax laws has recently permitted the deduction of asset depreciation only from rentals for the purposes of taxation. This is seen as an incentive for the leasing sector.

By the end of 1994, 23 LCos., were listed in the KSE. The information about these companies is provided in table-6 and summarized in charts 15, 16 and 17 respectively, for profit after tax, EPS and net investment in leasing[2]. The cumulative net investment of these companies in leasing activities in 1994 increased to Rs. 9.4 billion from Rs. 8.9 billion in 1993. The cumulative after tax profits of the sector stood at Rs. 440.6 and 439.34 million, respectively, in 1993 and 1994. The mean EPS improved from Rs. 1.7 in 1993 to Rs. 2.2 in 1994.

Compared to MCos., for the LCos., the stock market is not an inevitable institution. Indeed, many LCos., get listed after acquiring a certain level of operational experience. This is not possible for the *Modarabas.* LCos., can and do borrow money on the basis of interest. Several LCos., have long-term credit lines with banks and even international financiers. This is not the case with *Modarabas,* which have opted not to deal in interest. *Modarabas* do receive short-term mark-up funds from banks. But most leasing operations involve long-term investment, therefore, MCos., involved in leasing activities cannot benefit much from such credit compared to the LCos.

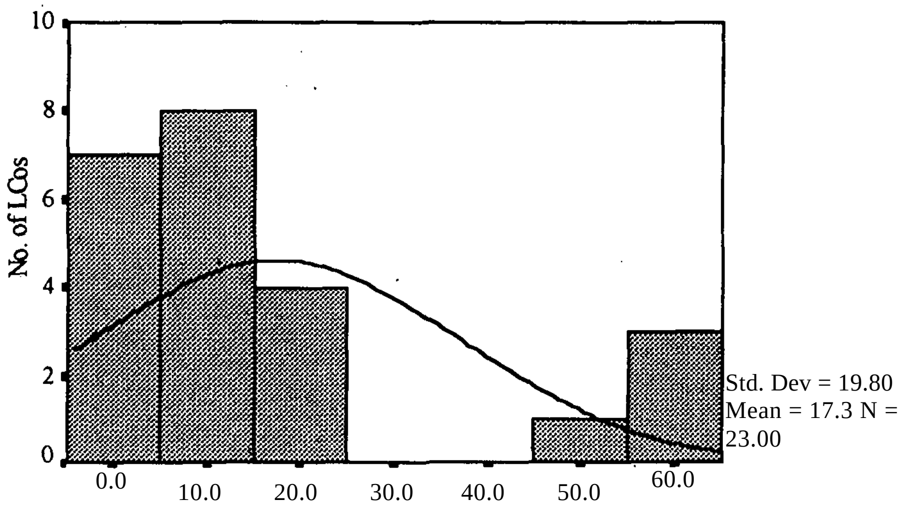
LCos., to a larger extent and MCos., to some extent depend on banks for acquiring credit. On the other hand, banks compete with these companies in the leasing business. Compared to the LCos., and MCos., banks have, thus, a better access to cheaper finance. Therefore, even in their own area of specialization, LCos., and MCos., are at a disadvantage compared to banks.

CHART 15 (A)



After Tax Profits 1993 (million Rs.)

CHART 15 (B)



After Tax Profits 1994 (million Rs.)

CHART 16(A)

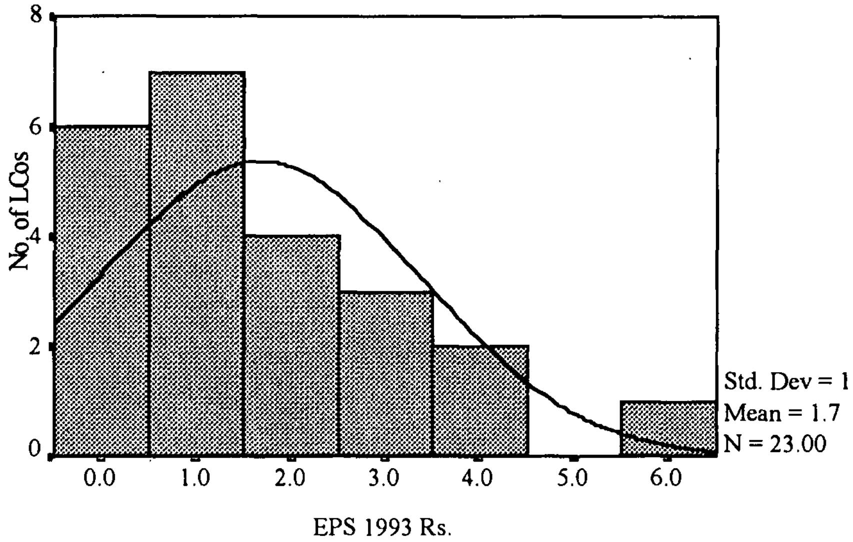


CHART 16 (B)

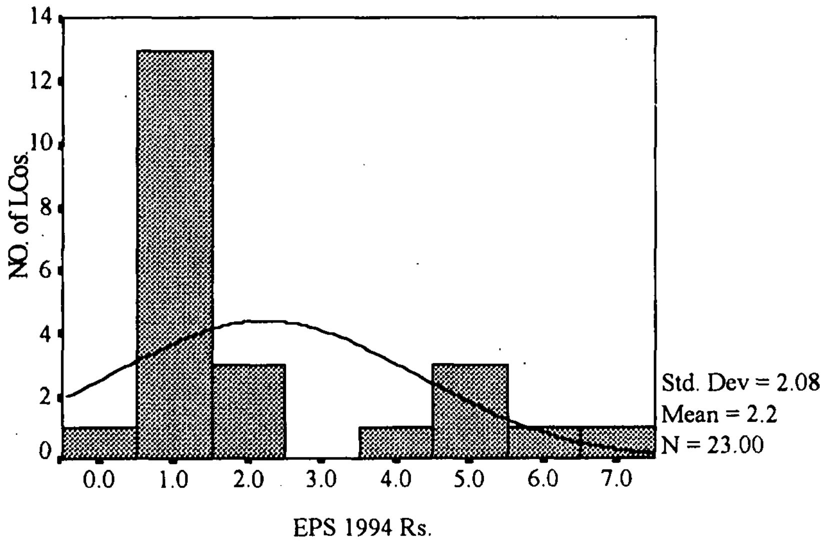


CHART 17(A)

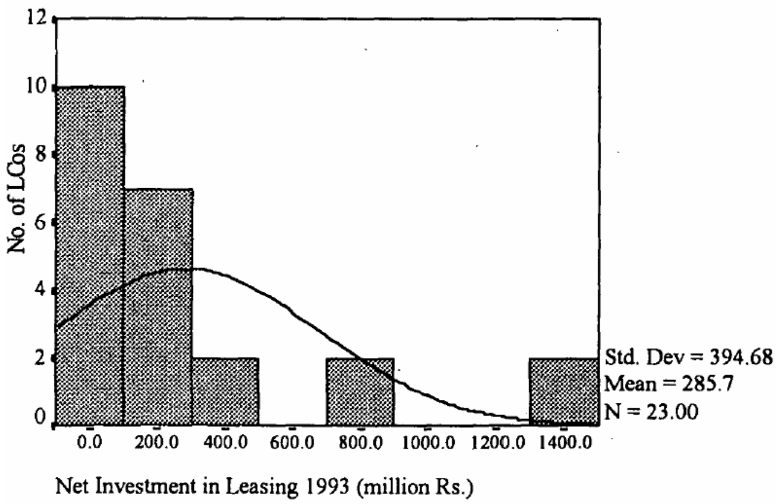


CHART -7 (B)

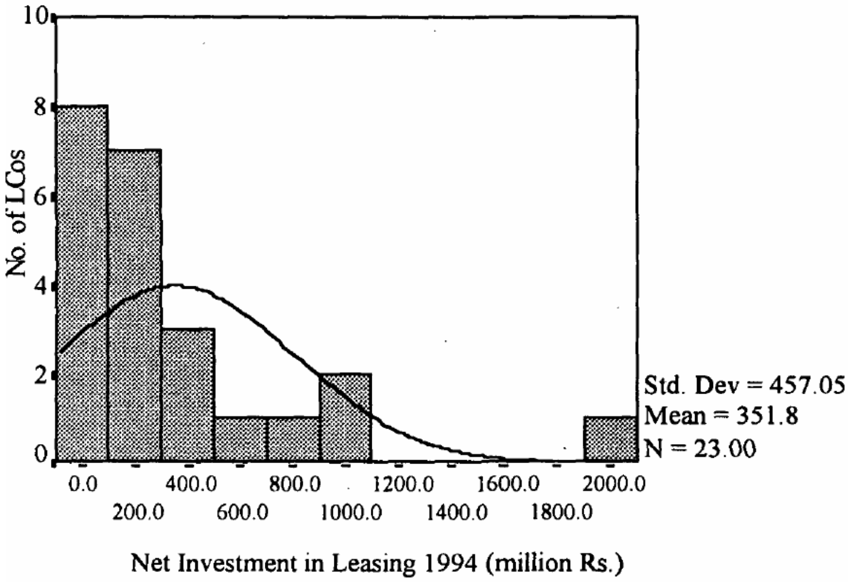


TABLE 6

PROFILE OF LEASING COMPANIES

Name of LCo.	Year of Listing	NIL 1993 Rs. (M)	NIL 1994 Rs. (M)	PAT 1993 Us. (M)	PAT 1994 Rs. (M)	EPS RS. 1993	EPS Rs. 1994
Asian	1990	408.2	428.6	20.70	13.44	2.9	1.56
Askari	1993	203.3,	539.3	6.50	23.60	.7	2.36
Atlas **BOT**	1989	740.0	973.0	18.20	24.20	3.3	4.00
Capital **Asset**	1993	39.5	53.0	2.90	3.00	.6	.60
Crescent	1992	88.8	121.2	2.50	3.80	.5	.50
Dadabhoy	1992	23.2		2.60		.4	
English	1992	144.1	153.3	18.70	9.80	2.3	1.23
First	1992	286.3	367.6	29.90	16.50	2.3	1.27
Ghemni	1992	191.3	188.7	11.40	7.60	2.3	1.51
Inter **Asia**	1993	81.6	83.1	8.30	10.00	.8	1.00
International Multi	1991	104.2	105.0	5.60	3.40	1.1	.69
Lease Pak Ltd.	1983	33.0	82.3	.00	6.10	_ .0	1.02
National	1991	141.5	.126.2	5.60	4.70	.6	1.01
N. **D.** L.C	1985	2356.0	1668.0	124.60	70.90	3.0	1.37
N. **Motor**	1994	77.7	67.4	4.90	2.60	.0	.49
Orix	1986	1371.0	1932.0	40.60	53.10	6.2	7.33
Pak Ind. **& Cam.**	1988	332.4	371.9	16.20	20.00	3.2	5.08
Pak Ind.	1989	1347.0	1053.0	55.90	42.10	5.3	3.47
Standard Chartered	1991	710.0	779.0	42.90	58.80	4.3	4.90
Trust	1992	212.0	292.6	22.60	60.00	2.3	6.01
Union	1994		21.0		5.70		.57
Sum		8891.1	9406.0	440.60	439.34		
Mean		444.6.	470.3	22.03	21.97	2.1	2.30
Minimum		23.2	21.0	.00	2.60	.0	.49
Maximum		2356.0	1932.0	124.60	70.90	6.2	7.33
N		20	20	20	20	20	20

Abbreviations: NIL, net investment in leasing; PAT, profits after tax; EPS, earnings per share

Source: Derived from *Pakistan and Gulf Economist*, Karachi, various issues.

3.3 OVERALL MARKET-STATUS OF MODARABAS

The companies listed in the KSE are classified into 28 sectors (see, table- *7). Modarabas,* LCos., and financial institutions are considered as separate sectors. The information provided in table-7 (a) is sorted for companies on the basis of their numbers. Although on June 31, 1994, about 53 MCos., were listed in the KSE, for 49 companies complete information was available.

It can be seen that in terms of numbers, the *Modaraba* sector largest as it is second in rank on descending order, financial institutions rank sixth, LCos.. rank thirteenth and mutual funds rank eighth. In terms of total size of the paid-up capital, the 7.4 billion rupees of the MCos., keep these companies in the fourth position. Whereas, financial institutions with a total paid-up capital of 9 billion rupees rank second and LCos., are in the twelfth position with 2 billion rupees capital.

The total paid-up capital of the *Modarabas* constitute 9.35% of the total KSE paid-up capital. Whereas, financial institutions contribute 11.34% of the total KSE capital. The contribution of the leasing sector is a mere 2.56%. But looking at the market capitalization, the significance of different sectors is changes to different positions. With a total about Rs. 10 billion market capitalization, *Modarabas* move to the thirteenth position in the ranking, contributing only 2.57% to the overall KSE capitalization. Whereas, banks move to the third position with Rs. 47 billion capitalization and 12% contribution to KSE capitalization. In terms of capitalization leasing gained value about five times of their paid-up capital, at almost the same amount of Rs. 10 billion capitalization as MCos., and 2.5% contribution to KSE capitalization.

Useful comparisons can be made on the basis of some average figures. The size of an average company suggests that MCos., are rather more capital intensive compared to an average company on the KSE list. The size of an average MCos' paid-up capital is Rs. 152 million, whereas, the market average for the same is Rs. 146 million.

The size of the paid-up capital of an average financial institution (Rs. 282 million) is much larger compared to the MCos. Compared to this, the size of an average LCo's paid-up capital is much smaller at Rs. 93 million. The average size of a LCo., is much smaller compared to the market average. In this comparison, *Modarabas* are, thus, closer to the market average.

In terms of the average market capitalization both leasing and financial institutions out-perform *Modarabas.* The average market capitalization of a MCo., is Rs. 203 million compared to Rs. 1.5 billion for financial institutions and Rs. 452 million for LCos. In terms of the market - capitalization for an average company in the KSE (Rs. 650 million rupees) both *Modarabas* and leasing are weaker. Leasing, is nevertheless, much stronger compared to *Modarabas* whose average market capitalization is less than even 1 /3 of the market average.

In terms of the amount of shares in circulation, *Modarabas* come in the second position with a total amount of 779 million shares in circulation, compared to 298 million sector average for the KSE, 774 million for financial institutions and I70 million for LCos. Lesser shares are in circulation in the leasing sector compared to the average of the KSE, *Modarabas* and financial institutions. But looking at the average size of shares per company in the *Modaraba* sector, it can be noticed that average size is closer to the KSE average (16 million for *Modarabas* and 15 million for KSE sector average).

These comparisons provide some indications about the overall market performance of the various sectors. Table - 7(b) lists the various sectors in descending order on the basis of MVR. Sorting the sectors in terms of this crucial variable drops *Modarabas* to the bottom 25th position in a ranking among 27 sectors. Moreover, the MVR for *Modarabas (I.34),* is much below the market average (5) for the 27 sectors. Compared to this, financial institutions and leasing maintained a sound MVR (5.2, 4.9). Their ranking is respectively 10th and 1 1 t h compared to 25th for the MCos. The ratio for financial institutions is 0.3 points above the KSE market average of 4.98 and the leasing sector faired as good as the market average. Obviously, these facts have to be reflected in the price earning and earnings per share. Again *Modarabas* are pushed to the bottom of the ranking compared to financial institutions and LCos.

Thus, our over-all assessment suggests that the *Modaraba is* a sizable sector in terms of number of companies and total capital listed. But in terms of performance comparisons, for the year 1994, the *Modaraba* sector is seen to be much weaker compared to the leasing sector and other financial institutions. The over-all market valuation suggests that to survive in the market, the *Modaraba* sector has to perform much better in the years ahead.

TABLE 7(A)

MODARABAS, LEASING COMPANIES AND BANKS: OVER-ALL STATUS IN THE KARACHI STOCK EXCHANGE (AS ON JUNE 31, 1994, OTHERWISE INDICATED)

Sectors	No of Cos.	Paid up Capital Rs.(M)	Average Size of Co. Rs. (M)	Capitalize-tion of Sector Rs (M)	Average Co. Capitallza-tion Rs.(M)	% of Sector Capital In KSE	%o of Sector Capitalization in KSE
Textile Spinning	150	10572,95	70,49	22462,68	149,75	13,29	5,80
MCos.	49	7438,86	151,81	9962,10	203,31	9,35	2,57
Textile Composite	42	4994,05	118,91	13829,46	329,27	6,28	3,57
Sugar &Allied	37	4007,53	108,31	8455,70	228,53	5,04	2,18
Chemical & Pharmaceutical	36	5817,06	161,59	76018,90	2111,64	7,31	19,61
Banks etc.	32	9018,47	281,83	47044,12	1470,13	11,34	12,14
Insurance	31	910,03	29,36	9731,34	313,91	1,14	2,51
Mutual Modarabas	28	1368,32	48,87	5241,67	187,20	1,72	1,35
Textile Weaving	26	2331,78	89,68	1930,16	74,24	2,93	,50
Miscellaneous	25	1103,92	44,16	2715,72	108,63	1,39	,71
Auto & Allied	23	2584,17	112,36	10806,14	469,83	3,25	2,79
Food & Allied	22	1511,83	68,72	19131,62	869,62	1,90	4,94
LCos.	22	2037,83	92,63	9936,00	451,64	2,56	2,56
Synthetic & Rayon	22	4068,37	184,93	29769,89	1353,18	5,11	7,68
Vanaspati & Allied	19	394,44	20,76	576,70	30,35	,50	,15
Engineering	17	967,40	56,91	3375,56	198,56	1,22	,87
Fuel & Energy	17	8I79,53	481,15	54042,98	3179,00	10,28	13,94
Cable & Electrical	16	700,87	43,80	6371,56	398,22	,88	1,64
Cement	16	3663,62	228,98	33411,94	2088,25	4,61	8,62
Paper &Board	15	890,78	59,39	6892,98	459,53	1,12	1,78
Glass & Ceramic	10	639,79	63,98	1548,93	154,89	,80	,40
Jute	9	427,58	47,51	446,55	49,62	,54	,12
Woolen	9	218,47	24,27	773,08	85,90	,28	,20
Leather & tannery	7	305;98	43,71	2164,67	309,24	,39	,56
Tobacco	7	519,69	74,24	3743,29	534,76	,65	,97
Construction	4	116,42	29,11	73,43	18,36	,15	,02
Transport	4	4773,03	1193,26	7117,96	1779,49	6,00	1,84
Sorted by No. of Cos.							
All figures rounded							
Sum		79562,77	3930,68	387575,12	17607,04	100,02	100,02
Mean		2946,77	145,58	14354,63	652,11	_ 3,71	3,70
Minimum		116,42	20,76	73,43	18,36	,15	,02
Maximum		10572,95	1193,26	76018,90	3179,00	13,29	19,61
N		27	27	27	27	27	27

TABLE 7(B)

MODARABAS, LEASING COMPANIES AND BANKS: OVER-ALL STATUS IN THE KARACHI STOCK EXCHANGE (AS ON JUNE 31, 1994, OTHERWISE INDICATED)

Sectors	PE 1993	PE 1994	No. of Co. shares	Average No. of shares	Valuation Ratio	EPS 1993	EPS 1994
Chemical & Pharmaceutical	24,550	22,620	599,160	16,643	13,060	5,540	6,010
Food & Allied	22,410	18,850	93,430	4,247	12,660	8,440	10,030
Insurance	15,500	14,530	110,960	3,579	11,000	5,800	6,020
Cement	14,870	21,040	427,020	26,689	9,120	6,240	4,410
Cable & Electrical	14,810	16,190	72,830	4,552	9,100	7,090	6,460
Paper & Board	3,860	3,090	98,980	6,599	7,720	2,590	3,230
Synthetic & Rayon	16,320	15,280	706,350	32,107	7,320	3,210	3,440
Tobacco	14,520	14,520	52,570	7,510	7,210	4,580	4,950
Leather & tannery	14,850	17,000	36,600	5,229	7,090	3,950	3,450
Fuel & Energy	22,050	23,830	714,240	42,014	6,600	3,920	3,630
Banks etc.,	24,380	19,120	773,850	24,183	5,220	2,440	3,110
LCos.	13,370	9,960	169,640	7,711	4,870	2,510	3,310
Auto & Allied	30,690	21,710	277,750	12,076	4,180	1,200	1,700
Mutual *Modarabas*	8,250	7,160	140,580	5,021	3,830	4,020	4,640
Woolen	48,310	14,080	21,850	2,428	3,550	,670	2,300
Engineering	.	.	103,710	6,101	3,490	-3,830	-2,460
Textile Composite	.	19,150	500,860	11,925	2,770	,150	1,480
Miscellaneous	10,180	.	54,580	2,183	2,460	2,610	,200
Glass & Ceramics	10,770	15,220	83,370	8,337	2,420	1,650	1,170
Textile Spinning	.	.	1089,000	7,260	2,120	-1,630	-,320
Sugar & Allied	15,000	17,600	320,290	8,656	2,060	1,570	1,340
Transport	11,000	19,130	475,120	118,780	1,470	1,320	,760
Vanaspati & Allied	.	.	39,440	2,076	1,460	-10,060	,010
MCos.	5,830	4,920	778,840	15,895	1,340	1,580	1,880
Jute	.	.	51,040	5,671	1,040	-2,000	-1,000
Textile Weaving	.	.	234,430	9,017	,830	-1,310	-,260
Sorted by Valuation Ratio; Capitalization/Paid-up capital All figures rounded. (.) implies missing value of variable due to non-availability. Case eliminated.							
Sum	341,520	352,330	8041,630	400,272	134,620	52,030	69,600
Mean	17,076	16,778	297,838	14,825	4,986	1,927	2,578
Minimum	3,860	3,090	15,140	2,076	,630	-10,060	-2,460
Maximum	48,310	37,330	1089,000	118,780	13,060	8,440	10,030
N	20	21	27	27	27	27	27

Source: Compiled and calculated from various issues of *Pakistan and The Gulf* **Economist, Karachi**

NOTES

1 The charts in this sub-section are based on KSE Brochures.

2 All charts of this sub-section are derived from table-6.

IV

DO *MODARABA* CERTIFICATES REWARD RISK?

Profit and loss sharing (PLS) principle of Islamic financing is considered unambiguously distinct from the interest-based system and therefore, widely cherished in the Islamic economic literature. For the PLS system to work efficiently, it must reward risk with matching rates of return. The actual performance of the PLS in this regard has so far been discussed only theoretically without any empirical evidence. *Modaraba* certificates (MCs) represent a pure form of the PLS. In this Section, we formally analyze the actual market performance of MCs. In this and subsequent sections of the paper, we discuss how the MCos., using the MCs., as a solitary Islamic financial instrument are incapable of successfully competing in a market environment where diverse forms of financial instruments are available to the competitors.

4.1 ON CAPITAL ASSETS PRICING IN AN ISLAMIC ECONOMY

In uncertain markets, the claim for a fixed and certain rate of return on pure financial capital is unanimously considered by the Islamic scholars to be the central cause of several economic inefficiencies and *inequities*. The theory of Islamic finance, as a corollary, rests on the natural phenomenon of the existence of risk, and as a result, on an uncertain rate of return on pure finance. Though Islamic scholars assign great social responsibilities to Islamic financial institutions, the rate of return is, however, the most crucial consideration of undertaking any financial activity. If the profit-sharing arrangement of Islamic financing has to function successfully, it must pass the actual test of performing in the market.

Investors, in both conventional and an Islamic framework, look for an accumulation of value for their wealth. In a world of uncertain markets, the accumulation of value by different companies is therefore crucial for their survival, as investors overtime, have to choose between them on the basis of this criterion.

On the Existence of Fixed Return Assets

Some Islamic economic discussions treat the deferred price underlying *bai ' murabaha lil amir bil shira* (mark-up) similar to interest due to its non-risk-sharing characteristics. Therefore, the existence of mark-up is considered as a characteristic of the transition process from the interest-based financial system to an Islamic one. Its role is thus ruled out from a truly PLS-based Islamic financial system. These analysis therefore, rule out the presence of a fixed return asset in an Islamic portfolio. Moreover, some researchers introduce *zakah* as a 2.5% financial penalty on holding cash as well as on the cash to be distributed as dividends[2].

The practical merits of these academic ideas are yet to be seen. However, for a number of reasons, the existence of a risk-free asset cannot and should not be ruled out from an Islamic economy. First, interest has been prohibited as a fixed return on pure finance. Indeed, the scholars of *fiqh* recognize that deferred price may contain a fixed return as a reward for the deferment of payment[3]. As this fixed return is a phenomenon of the goods and services market, in economic terms, this cannot be treated as a return on pure finance[4]. Islamic banks use this return with the consent of *fiqh* scholars. Second, risk aversion helps keeping the cost of capital low. Elimination or bypassing risk aversion by refusing the existence of a risk-free asset cannot be rationalized. Moreover, no Islamic scholar has argued that risk aversion is not acceptable in Islam. The only important injunction to be derived from the prohibition of interest is that if risk exists, it should be shared by mutual agreement between all parties to a contract. Third, the above mentioned academic ideas which decline the existence of a risk-free asset do not provide an alternative mechanism through which the cost of capital can be compared for different projects and for the same project with different life span. Fourth, the introduction of *zakah* as a 2.5% financial penalty will not make any difference as it would be a universal rate. Moreover, *zakah* contribution and for. that matter, contribution of interest-free loans both fall in the non-economic domain. The incorporation of these in considerations similar to the one in question lack approval from *shari'ah* scholars. Lastly, but most importantly, the market strength of the MC as a financial instrument would depend on the demand for it. This demand cannot be restricted to only those investors who believe in the non-existence of a fixed return investment. The imposition of this additional consideration will simply weaken the demand for the asset and will lead to a depreciation in its value overtime. For these reasons, we consider that the portfolio of an Islamic investor may contain a risk-free asset.

Therefore, in addition to risky investment opportunities, the legitimacy of the mark-up in the *shari'ah* provides the investors the opportunity to seek risk-free, but "qualified" fixed return investments. The coexistence of mark-up as a risk-free investment opportunity along side the risk bearing opportunities is known to improve the welfare of investors over a situation where only one of these opportunities may be available. Given these opportunities, and depending on their risk profile, investors must expect from risk-bearing investment opportunities, a reward over and above the risk-free mark-up rate, as a risk premium. The higher is the total risk over and above the risk-free rate, the higher must be the premium, its reward.

On Partitioning of Total Risk

The current literature on Islamic financing does not formally discuss the fact that risk cannot be diversified completely. In this literature, risk refers, in general, to uncertainty or total risk of a project or economic activity involving time. This is not without reason. In the context of investment projects which are new or which relate to non-listed enterprises, risk can only refer to the uncertainty of the future outcome of such projects, which is the total risk of the project.

However, the situation of companies listed in the stock exchanges is different. In these cases, not only total risk of new opportunities in investing in the stocks can be calculated precisely, but also this risk can be partitioned into firm specific and market related, respectively, diversifiable and non-diversifiable risk. In competitive markets, the diversifiable risk should not exist and it is the non-diversifiable risk which needs to be rewarded[5].

This theoretical framework of evaluation and pricing of capital assets under conditions of risk is thus, equally applicable to the evaluation of profit sharing arrangements as long as these are listed in the capital markets. Since the MCos., are listed, and MCs., are traded, these can be evaluated using the framework.

4.2 REWARD FOR RISK

In the framework of the premises referred to above, i.e., under conditions of risk, investors view the outcome of investments in terms of some probability distribution. The investment decisions are made in terms of a) the expected value of the probability of outcome of an investment and b) its standard deviation. The utility function of a typical investor is thus written as:

$$U = f(E_w, \sigma_w)$$

E_w is expected future wealth; σ_w is predicted standard deviation of actual future wealth from the expected, E_w. Since expected future wealth depends on expected future return R on present investment, and the standard deviation of the R, σ_R, investor's utility function directly depends on the expected R.

$U = g(E_R, \sigma_R)$
$dU/dE_R > 0$; Higher expected return is preferred to lower expected return, and
$dU/d\sigma_R < 0$; Lower risk is preferred to higher risk.

These rational assumptions imply up-ward sloping indifference curves relating to E_R, and a_R. Each E_R, OR combination reflects a unique investment opportunity. Investment opportunities lying on higher indifference curves improve welfare of the investor over lower indifference curves (in Figure - A, the tangency of these indifference curves, not shown, will correspond to points A, B and C, respectively, for lower, middle and higher curves).

All investment possibilities other than the risk-free opportunity will involve certain level of risk. An efficient investment plan, like point C in Figure - A, will be chosen by the investor by ensuring:

1. No alternative with the same E_R, but with lower a_R is possible,
2. No alternative with the same a_R and higher E_R, is possible and

3. No alternative with a higher E_R, and a lower a_R is possible.

All investors have also the possibility of borrowing and/or investing at a risk-free rate and share equal amount of information of the market. Under these conditions, combination of efficient investments (E;) will fall along a straight line, similar to OC' and OB' in Figure A. E; = R_f + ba; ; R_f Risk-free rate, b, is risk premium, which will always be positive as investors prefer lesser risk over more.

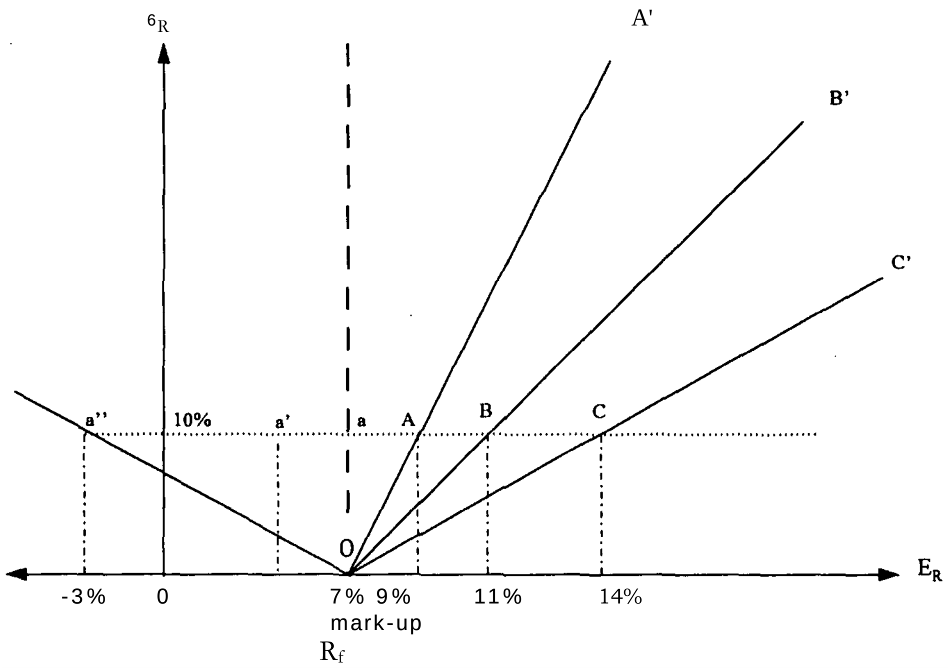


Figure A: E_R and σ_R Relationship under Presence of R_f

Given that an investor can receive credit or invest at a risk-free rate (R_f) and have the choice to invest in risky stocks with expected outcome subject to (Ei, ai), then by allocating his funds between the R_f and risky investment, the investor can attain the best point which gives highest value for (E; - Rf)/a, i.e., the investor will maximize the reward for risk.

While comparing individual stocks (or portfolios), for a level of risk, efficient stocks should give higher return. Conversely, for a level of return, efficient stocks should be lesser risky. In Figure A, stock C is the most efficient at the risk class of 10% variability of return, given the risk-free (R_f) mark-up rate which we assume as 7% for Pakistan for the period of the study.

We calculate **reward** (average monthly return on MCs and stocks minus the 7% annual risk-free mark-up rate adjusted on monthly **basis)/variability** of average return ratio to find how the MCs and stocks of the companies in our sample have rewarded the risk over and above the 7% rate. The existence of stocks close to or lower than the risk-free rate (e.g., points A, a and so on, compared to B and C will indicate non-economic (may be ideological) determinants of investment decisions, suggesting need for improvements in performance. Obviously, if the market rewards risk the prospect for risk-sharing *(mudharabah* and *mudharakah)* would be high. We use two indices, the Sharpe Index and the Treynor Index as a measure of the reward for variability of return.

The Sharpe Index is calculated as: **Expected rate of return on an asset *minus* the risk-free mark-up rate** *divided by* **variability of the rate of return on the asset** (measured by the standard deviation of average monthly expected return). Hence,

$$SI = \frac{R_E - R_F}{V}$$

The Treynor index, replaces variability of return by the beta, non-diversifiable risk of the asset. Therefore, the

$$TI = \frac{R_E - R_F}{Beta}$$

Data

Karachi Stock Exchange (KSE) is the main stock market (see, previous sections). Systematic information about the KSE is provided by at least two sources. Since 1961, the State Bank of Pakistan publishes systematic information about certain aspects of the companies listed in the market. Since 1991, KSE has also started to provide information about selected companies. This useful information unpublished and distributed among the members of the KSE only. This section relies mostly on the SBP sources, except for the use of the KSE sources in a few places. Using the SBP data, in this section, we calculate the Sharpe and Treynor Indices, for MCos., LCos., and banks. The SBP index of share prices, (SBPI) is treated as the market index. The composition of sectors which make the SBPI is given in Table 8.

TABLE 8

SECTORAL COMPOSITION OF THE SBPI OF SHARE PRICES

No. of Sectors	Name of Sectors	No. of Companies.
1.	Textiles	24
2.	Chemical and pharmaceuticals	8
3.	Engineering	4
4.	Auto and Allied	7
5.	Cables and Electrical	5
6.	Sugar and Allied	8
7.	Paper and Board	5
8.	Cement	5
9.	Energy and Fuel	6
10.	Transport and Communication	5
11.	Banks	5
12.	*Modarabas*	*8*
13.	Issuance	4
14.	Leasing	5

Expected Return, Variability of Return and Betas

The performance of individual stocks is measured by studying the return on the stock in question in relation with the market rate of return (return on SBPI). The prices of most stocks move together in a systematic fashion. Pakistan's main market - the Karachi Stock Exchange has been suffering serious instability due to socio-political strife. This and similar other causes of instability are in general common to all stocks. In normal circumstances, on the average, 25-30%[6] of total instability in prices of individual stocks are counted for the instability of the market due to similar socio-political, technological and market conditions. However, some stocks follow the market more than others - having more than average systematic risks and vice-versa. The firms having more than average risk characteristics are in general leveraged, firms whose assets depreciate fast, firms having cyclical sales and firms engaged in the basic industries. A large part of instability (in general, 70-75%, in average) in the rate of return on stocks of individual firms is, however, due to individual characteristics of the firms and are unsystematic. In competitive markets, this risk is eliminated and not rewarded. So, it is the degree of the systematic risk of a stock which counts.

The Model

To analyze the performance of individual stocks in relation to the market, following the seminal works of Treynor and Sharpe, the simplified variant of capital asset pricing model under conditions of risk as given below is utilized'. This simple model is extremely useful in calculating a stock's systematic and unsystematic risk, i.e., its relationship and performance vis-a-vis the market and for assessing how a stock rewards per unit of risk. The general form of the model to estimate the regression line is

$$r_{it} = a_i + b_i \, r_{mt} + e_t$$

r_{it} return on the stock of an individual company in period t, the dependent variable of the model, is calculated as:

$$r_{it} = (p_{t+1} - p_t + d_t) / p_t$$

p_t beginning of period market price of individual stock
p_t+_1 end of period t price of same stock
d_t cash dividend in period t for individual stock
r_{mt} is return from market in period t - independent variable of the model,. calculated as,

$$(SBPI_{t+1} - SBPI_t) / SBPI_t$$

$SBPI_{t+1}$ Rupee amount of the State Bank Index of 100 companies at the end of period t and $SBPI_t$ Rupee amount of the SBPI index at the beginning of period t. Monthly r_1 for 18 companies (8 MCos., 5 LCos., and 5 banks) and r_{mt} calculated for 27 months (November 1, 1991 - January 1, 1994) as such are given in table 12. The period of 27 months has been selected as it is generally accepted that for such purposes a period of 25 - 30 months is an ideal period.

The regression intercept a_t estimates the rate of return on individual stock r; when return on the SBPI is stationary i.e., the r_mt 0. The slope statistic b_1 gives the predicted response of ri to changes in r_m - the ***beta*** index of the non-diversifiable systematic risk of the individual stock. This component of risk is crucial, because the remaining part of risk, which is specific to the stock in question can be eliminated by diversification. e_t is the random error around the regression line which occurs in period t. For a specific stock then, the regression model becomes:

$$r_i = a_i + b_i r_m$$

We apply this model to the data of table 12 to run regression for the rate of return of the 18 companies as dependent variable and rate of return on the market index as an independent variable. The resultant betas (separation of systematic and unsystematic risk of companies), standard deviation, Sharpe and Treynor indices are given in tables 10 and 11.

Sector Comparisons

The results of inter-sector comparisons in terms of risk-reward as given by the Sharpe Index are provided in table-9. These results suggest that the *Modaraba* sector does not at all reward risk. The risk adjusted return for the *Modaraba* sector is 15% below the fixed return on markup-based investments. In fact, *Modaraba* is the only sector which is characterized with this phenomenon. Compared to this, investment banks and LCos., perform much better. The cement sector gives maximum reward for risk followed by the chemicals and pharmaceutical companies.

Company Comparisons

The Sharpe Index and Treynor Index calculated for the 18 companies are given in table-10. These suggest that the return adjusted for total risk as well as adjusted for systematic risk offered by 3 MCos., falls below the markup rate. One leasing and one investment bank fall to the lowest position in this regard. The risk adjusted return offered by the other 5 MCos., is slightly above the markup-based return amongst which 2 offer above average risk adjusted return, in this classification.

TABLE 9

SECTORS: AVERAGE MONTHLY RATE OF RETURN AND ITS VARIABILITY

FOR OCTOBER 1991-JANUARY 1994

	Market (1)	MCos. (2)	LCos. (3)	Insurance (4)	Banks (5)	Textiles (6)	Ch. & Ph. (7)	Engen (8)	Auto. (9)	Cbl. & El. (10)	Sugar (11)	Paper (12)	Cement (13)	Fuel &E (14)	Tran & C (15)
ER	2.72	-0.67	2.46	5.7	2.63	0.83	3.45	2.69	2.66	3.04	2.8	2.5	7.24	3.96	2.92
ôR	7.94	9.05	8.21	12.15	13.62	6.8	7.59	9.62	8.19	8.76	7.12	7.34	9.9	11.97	12.99
SI	0.259446	-0.15	0.22	0.4148	0.145	0.025	0.37	0.21	0.244	0.2717	0.301	0.251	0.665	0.277	0.174

Source: Derived from various issues of *Statistical Bulletin State Bank of Pakistan*

TABLE 10

SHARPE AND TREYNOR INDICES FOR BANKS, LEASING AND *MODARABA* COMPANIES

	CIB	BE	IIB	PIB	PICIC	AL	NAL	NDLC	OL	SCL	ALM	BFM	BRR	GM	HBM	LTVM	SM	TM
SI	0.22	0.25	0.08	-0.1	0.14	0.2	-0.1	0.32	0.29	0.17	-0	-0.1	0.05	0.11	0.06	0.11	-0.2	0.13
TI	5.23	9.69	2.46	-1.96	8.5	3.08	-3.95	12.5	6.05	4.14	-0.37	-2.55	1.16	4.05	8.27	2.62	-3.93	5.86

Source: Derived From Table 11.

Abbreviations:

Indices
SI Sharpe Index
TI Treynor Index

Investment Banks
CIB Crescent Investment Bank
BE Banker's Equity
IIB Islamic Investment Bank
PIB Prudential Investment Bank
PICIC Pakistan Industrial Credit and Investment Corporation

LCos.
AL Asian Leasing
NAL National Assets Leasing
OL Orix Leasing
SCL Standard Chartered Leasing
NDLC National Development Leasing Corporation

MCos.
ALM Almali Modaraba
BFM B . F. Modaraba
BRR B. R. R. Capital Modaraba
GM 1st Grindlays Modaraba
HBM 1st Habib Bank Modaraba
SM 1st Sanaullah Modaraba
TM 1st Tawakal Modaraba
LTVM L. T. V. Modaraba

Both in terms of the Sharpe and Treynor indices, the reward for risk offered by 35.5% of MCos., 20% of LCos., and 20% of investment banks is below the 7% annual bench mark of fixed rate of return. On the average, MCos., do not at all, and LCos., and investment banks do reward total risk. But MCos., do offer 2 units of reward per unit of systematic risk. This is half of the reward offered by LCos., and investment banks. These findings highlight the fact that MCos., compared to both LCos., and investment banks have inherent problems both in relation to the market and within the industry.

TABLE 11

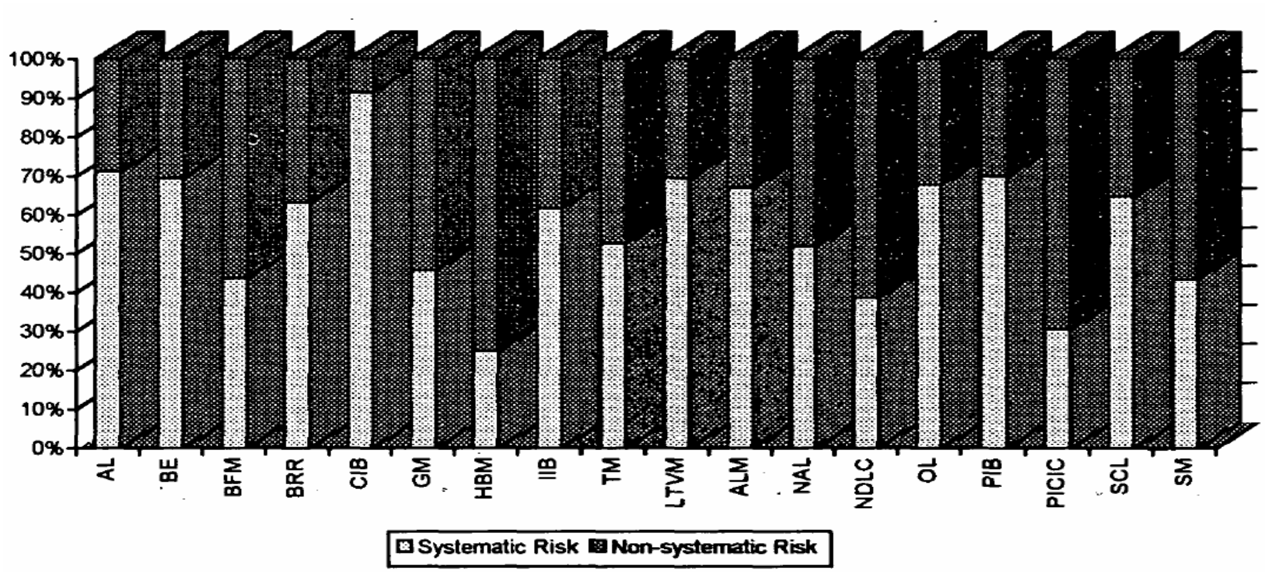
MONTHLY RISK ADJUSTED RATES OF RETURN ON *MODARABA* CERTIFICATES AND STOCKS OF LEASING COMPANIES AND INVESTMENT BANKS LISTED IN KSE (1/11/1991-1/1/1994)

1 Companies	2 R1-dividend	3 Rtt+dividend	4 Rtt (3-markup)	5 V of Rtt	6 Beta of Rtt	7 SV(6%o5)	8 USV(5-7)	9 SI(4/5)	10 TI(4/6)
1. AL	1.79	2.79 .	2.19	11.16	0.712	7.94592	3.21408	0.1962366	3.075842697
2. BE	6.32	7.32	6.72	26.66	0.695	18.5287	8.1313	0.252063	9.669064748
3. BFM	-0.91	-0.51	-1.11	9.34	0.436	4.07224	5.26776	-0.118844	-2.54587156
4. BRR	-0.13	1.33	0.73	14.18	0.632	8.96176	5.21824	0.051481	1.155063291
5. CIB	4.39	5.39	4.79	22.11	0.915	20.23065	1.87935	0.2166441	5.234972678
6. GM	0.2	2.45	1.85	16.14	0.457	7.37598	8.76402	0.1146221	4.048140044
7. HBM	1.66	2.66	2.06	34.01	0.249	8.46849	25.54151	0.0605704	8.273092369
8. IIB	1.12	2.12	1.52	18.77	0.618	11.59986	7.17014	0.0809803	2.459546926
9. TM	2.01	3:68	3.08	22.89	0.526	12.04014	10.84986	0.1345566	5.855513308
10. LTVM	1.42	2.42	1.82	16.68	0.695	11.5926	5.0874	0.1091127	2.618705036
11. ALM	-1.98	0.35	-0.25	10.35	0.669	6.92415	3.42585	-0.024155	-0.37369208
12. NAL	-2.45	-1.45	2.05	15,95	0.519	8.27805	7.67195	-0.128527	-3.94990366
13. NDLC	4.42	5.42	4.82	15.25	0.387	5.90175	9.34825	0.3160656	12.45478036
14.OL	3.71	4.71	4.11	14.17	0.679	9.62143	4.54857	0.2900494	6.053019146
15. PIB	-1.77	-0.77	-1.37	15.62	0.7	10.934	4.686	-0.087708	-1.95714286
16. PICIC	2.21	3.21	2.61	18.99	0.307	5.82993	13.16007	0.1374408	8.501628664
17. SCL	2.29	3.29	2.69	15.49	0.649	10.05301	5.43699	0.1736604	4.144838213
18. SM	-2.11	-1.11	-1.71	9.26	0.435	4.0281	5.2319	-0.184665	-3.93103448
Rm_t	2.72	4.72	4.12	7.94					

Note: Monthly returns for individual companies (Rita) are adjusted for dividends where available; mean values are used where such information was not available.
Abbreviations: SV, systematic variability; USV, unsystematic variability; SI, Sharpe Index; and TI, Treynor Index
Also see, Table-10
Source: Derived from Table 12.

CHART-18

SYSTEMATIC AND NON-SYSTEMATIC RISK OF THE COMPANIES



Source: Derived from Table 11.
Note: For abbreviations see, Table-10

TABLE 12

MONTHLY RATE AND VARIABILITY OF RETURN ON MARKET PORTFOLIO (R_{MT}) AND INDIVIDUAL STOCKS (R_{ITS})

PERIOD	Monthly return on Asian Leasing	Monthly return on Bankers' Equity	Monthly return on BF *Modaraba*	Monthly return on BRR *Modaraba*	Monthly return on Crescent Investment Bank	Monthly Return on Grindlays *Modaraba*	Monthly return on HB *Modaraba* First	Monthly return on Islamic Investment Bank	Monthly return on Tawakal M First
01-NOV-91	9.14	83.16	4.30	8.13	64.24	18.09	10.69	27.63	9.43
01-DEC-91	33.33	51.82	11.24	14.29	33.87	28.51	-3.46	32.99	86.21
01-JAN-92	-9.30	-.48	-9.09	-6.58	-18.07	-4.28	-11.94	-17.05	-7.41
01-FEB-92	-14.10	-29.47	.00	-15.49	-23.53	-20.00	-21.19	-12.15	-12.00
01-MAR-92	3.73	17.12	.00	15.00	3.85	36.16	18.28	-15.96	35.23
01-APR-92	20.86	-16.37	-1.85	3.19	30.09	-35.74	2.18	2.53	-29.41
01-MAY-92	3.57	60.14	-20.75	-43.12	-16.01	-11.73	-20.28	-32.59	-21.43
01-JUN-92	-4.60	-15.11	-.95	-7.41	-15.25	-5.78	-15.18	31.87	-21.21
01-JUL-92	-10.84	-23.87	-13.46	-9.87	-15.00	-9.20	-9.21	-11.11	-.77
01-AUG-92	2.70	-15.54	-12.22	-.89	-14.12	-9.73	-18.84	-18.75	-14.73
01-SEP-92	5.26	18.40	12.66	-1.49	4.11	6.29	-50.71	11.54	11.36
01-OCT-92	5.00	.00	-7.30	-6.06	-7.89	-15.49	86.96	1.72	-1.63
01-NOV-92	-11.90	-12.84	-7.88	-9.68	-10.71	.33	-53.49	-13.56	-6.64
01-DEC-92	2.03	-6.20	11.84	11.43	5.60	10.47	115.00	12.55	4.44
01-JAN-93	7.02	-5.79	-5.29	.00	2.27	-7.82	8.53	-6.62	38.30
01-FEB-93	-2.23	-10.53	.62	-11.86	-9.63	-22.51	-13.21	-3.36	-6.46
01-MAR-93	-2.53	-5.88	-4.32	4.00	-16.39	3.16	-2.88	-16.99	6.91
01-APR-93	-15.97	-8.75	9.68	-16.78	-7.45	14.69	-22.03	-9.30	-19.38
01-MAY-93	-2.32	-4.11	-11.76	8.40	12.92	18.33	5.43	11.79	7.63
01-JUN-93	13.92	30.95	.00	8.53	3.19	.00	10.82	-1.38	.35
01-JUL-93	7.64	19.09	1.33	-5.36	9.09	-3.76	.47	-2.33	7.77
01-AUG-93	-15.48	-16.79	-11.84	-16.98	-17.00	-19.84	-20.37	-2.38	-6.23
01-SEP-93	.00	8.62	-2.99	10.00	10.44	8.38	7.56	14.63	-18.53
01-OCT-93	5.34	11.49	.00	19.83	32.73	8.81	9.19	10.64	-1.29
01-NOV-93	.00	-4.55	15.38	8.62	24.66	3.31	11.39	.00	-2.17
01-DEC-93	5.07	14.29	4.00	14.29	47.25	7.20	11.11	50.00	4.89
01-JAN-94	13.10	31.94	14.10	22.22	5.22	10.45	10.00	-14.10	11.02
E_R	1.79	6.32	-.91	-.13	4.39	.20	1.66	1.12	2.01
σ_R	11.16	26.66	9.34	14.18	22.11	16.14	34.01	18.77	22.89

(Cont'd)

PERIOD	Monthly return on LTV *Modaraba*	Monthly return on *Modaraba* Al Mali	Monthly return on market portfolio of 100 securities	Monthly return on National Asset Lease	Monthly return on NDLC	Monthly Return on Orix Leasing	Monthly return on Prudential Investment Bank	Monthly return on PICIC	Monthly return on Standard Chartered Leasing	Monthly return on Sanaullah *Modaraba* First
01-NOV-91	.00	20.44	19.85	9.89	25.00	33.05	4.23	76.92	40.91	3.23
01-DEC-91	-2.44	9.09	17.18	34.00	14.53	3.16	10.81	11.30	-25.81	11.72
01-JAN-92	-4.50	-.56	1.57	-16.42	-22.39	-7.48	-19.51	-2.34	4.35	-7.69
01-FEB-92	-12.04	-15.64	-10.31	-17.86	5.38	-5.51	-16.67	-17.20	-35.42	-2.27
01-MAR-92	4.76	-27.15	.57	-6.52	2.19	12.45	7.27	6.28	41.94	-.78
01-APR-92	-11.36	-6.36	8.00	-4.65	32.14	-.35	-5.08	10.00	4.55	-3.13
01-MAY-92	-16.67	-10.68	.00	-8.54	-12.16	-1.39	-10.71	-27.27	-5.43	-14.52
01-JUN-92	-1.54	-21.52	-4.23	-1.33	.00	36.62	-16.00	.57	5.75	-17.36
01-JUL-92	-7.81	-5.82	-7.73	-5.95	-9.23	-19.59	-14.29	-14.12	1.09	-11.87
01-AUG-92	-21.19	5.88	-5.99	-13.79	5.08	-12.82	-8.33	-9.87	-12.37	-.26
01-SEP-92	-1.08	-2.78	2.55	-4.00	-5.65	-1.47	7.58	6.57	-2.45	2.60
01-OCT-92	-21.74	.00	1.24	-7.99	-2.56	19.40	.00	5.14	3.77	7.59
01-NOV-92	27.78	-2.86	-1.84	-18.87	5.26	-5.54	.28	-7.17	6.67	-5.18
01-DEC-92	-8.70	2.35	2.50	16.28	2.00	2.88	3.93	8.07	-7.39	.50
01-JAN-93	-9.52	-.86	1.22	-4.00	5.39	-.96	-11.62	1.95	3.07	1.98
01-FEB-93	-3.95	-4.93	-4.22	-12.50	1.55	-1.62	-12.84	-4.46	8.93	-.73
01-MAR-93	4.11	-4.88	-3.77	-3.81	1.07	-.99	-12.28	-8.00	-1.64	-10.49
01-APR-93	.00	-10.26	-4.58	1.98	3.47	10.00	-21.60	-5.80	-3.89	-19.89
01-MAY-93	2.63	.71	5.48	11.65	3.65	-3.03	-3.06	-20.00	4.05	8.16
01-JUN-93	19.23	-4.96	5.19	-13.91	-11.27	2.50	23.68	-2.88	10.56	-7.23
01-JUL-93	2.15	2.61	4.94	-4.04	3.97	25.61	-14.89	18.81	4.52	6.78
01-AUG-93	-15.79	-9.09	-4.71	-23.68	4.58	-13.59	.00	-14.17	1.44	-15.87
01-SEP-93	3.75	2.00	1.23	-10.34	-3.65	-9.10	-9.00	.97	-1.90	-3.77
01-OCT-93	39.76	14.51	14.02	36.92	3.79	-3.89	34.62	8.17	.00	15.69
01-NOV-93	6.90	-2.40	5.88	-13.48	19.71	9.32	-8.16	16.00	7.73	-3.39
01-DEC-93	45.16	7.02	18.18	29.87	56.10	4.71	42.22	19.54	16.59	12.98
01-JAN-94	20.56	12.79	11.11	-15.00	-8.59	27.81	1.56	2.56	-7.69	-3.73
E_R	1.42	-1.98	2.72	-2.45	4.42	3.71	-1.77	2.21	2.29	-2.11
σ_R	16.68	10.35	7.94	15.95	15.27	14.17	15.62	18.99	15.49	9.26

Source: Calculated from various issues of the *Bulletin State Bank of Pakistan*

Betas

The average beta for the 18 companies is 0.60, i.e., the unavoidable systematic risk of these companies is 60%, leaving 40% of the unsystematic risk which can be diversified away. These 18 companies cannot be representative of the market which consists about 700 companies. Nevertheless, this is indicative of the fact that the KSE is almost three times more riskier compared to some developed market economies, as the average beta for a developed market is considered to be 0.25 which leaves the diversifiable risk to 75%. The higher risk of our example of the KSE is consistent with the existence of higher rate of return in the developing countries compared to the developed countries and offers better investment opportunities. It should be noted that betas for the same company changes overtime. Thus it is often more useful to depict the stability of betas over time. But due to limited availability of data, it was not possible for me in the present study to check for this characteristic.

Unsystematic and systematic risk, partitioned, company-wise for our sample is given in table-11. Non-risk-rewarding companies constitute a larger part of the average systematic risk of our sample of 18 companies. According to experience based conventional wisdom, riskier companies should offer higher return, but in this sample they, do not. Risk-rewarding companies have relatively lower systematic risk. This sounds paradoxical, but is consistent with our finding that some companies are simply riskier than others irrespective of what they can offer in return.

Inter Sector Linkages

It is also interesting to see that with what sectors of the economy the MCos., and LCos., are integrated? Given the nature of this research and the data used for it, we can only translate the inter-sector linkages in terms of the movement of share prices. The correlation coefficients of stock prices for different sectors for the period October 1991 - January 1994 is provided table 13. It can be seen that MCos., are inversely correlated with most other sectors except for textiles and banks. The correlation coefficients between MCos., banks and textiles are positive and strong indicating an integration and , strong linkages between these sectors. But comparatively, banks and MCos., have weaker, MCos.,-textiles, and Banks - textiles have stronger correlation. The correlation of leasing with these sectors are weak, but with most other sectors it is strong. It is also very interesting that only MCos., and transport have weak correlation with the market.

These are reasonable explanations for the strong positive correlation between MCos., and textiles. First, a good number of MCos., is floated by companies which have strong stake in the textile sector. Second, textile and MCos., are both on the down swing in the market. Since MCos., have negative correlation with most sectors, it seems during the week days of MCos., most investments have been diverted from MCos., to cement and chemicals. Similar is the case with textiles.

TABLE 13

MODARABAS: INTER-RELATIONSHIP WITH OTHER SECTORS

	SBPGI	MCos:::.	LCos	B&IBs	INSUR	Miscellan	Textile	CH&PH	ENG	Atit&All	Gebl&E	Sugar	Cement	Energy	Paper
SBPGI	1														
MCos	**0.20434**	1													
LCos	**0.96246**	0.08121	1												
B&IBs	0.75101	**0.784059**	**0.64161**	1											
INSURC	**0.81351**	**0.22899**	0.86771	0.334	1										
Miscellan	0.87154	0.040524	**0.83993**	**0.5555**	0.77577	1									
Textiles	**-.48591**	**0.880456**	**0.35776**	**0.8816**	-0.02156	**0.28289**	1								
CH&PH	**0.76605**	-0.42322	0.82317	0.2009	**0.88887**	0.78311	**-0.15649**	1							
ENG	**0.96288**	0.191163	0.94211	0.7275	**0.81874**	**0.80331**	0.422249	**0.7656**	1						
Aut&All	**0.75598**	-0.30397	**0.78396**	0.279	0.80006	0.87205	-0.04975	**0.92366**	**0.73835**	1					
Cabl&E	0.77655	**-0.32385**	0.79749	0.2707	**0.81103**	**0.68467**	0.031791	**0.86751**	**0.73525**	0.7541	1				
Sugar	**0.82539**	**-0.23665**	**0.83391**	**0.3638**	**0.89844**	**0.8631**	-0.02766	**0.95007**	**0.80883**	**0.92011**	0.801	1			
Cement	0.74861	**-0.42398**	**0.80908**	**0.1756**	**0.95378**	**0.755**	-0.19958	**0.9601**	**0.75546**	**0.86**	**0.8466**	**0.92901**	1		
Energy	**0.96088**	**0.065965**	**0.93483**	**0.6503**	**0.81453**	**0.82031**	0.352828	**0.84114**	**0.9517**	**0.79932**	**0.835**	**0.86267**	**0.79498**	1	
Paper	**0.94119**	0.115522	**0.89285**	**0.6696**	**0.81605**	**0.91864**	**0.335885**	**0.8186**	**0.91833**	**0.84116**	0.7516	**0.9129**	**_ 0.79233**	**0.92236**	1

Source: Calculated from various issues of the *Statistical Bulletin State Bank* *of Pakistan.*

Abbreviations

SBPGI	**State Bank General Index of Share Prices:**
MCos	***Modaraba* Companies**
LCos	**Leasing Companies**
B&IBs	**Banks**
INSURC :	**Insurance Companies**
Miscellan :	**Miscellaneous**
Textiles .	All Textiles
CH&PH :	**Chemicals and Pharmaceuticals**
ENG	**Engineering**
Aut&All :	**Auto and Allied Industries**
Cabl&E :	**Cable and Electrical**

NOTES

1The PLS is mostly comprised *of mudharabah* and *musharakah* modes of Islamic financing. For a call to implement the PLS, see, e.g., CII (1981) and FSC (1995).

2 See, Ibrahim (1991), Mirakhor (1987) and Ashkar (1993).

3 Ibn Qudama is reported to have written that, "It is permissible if the seller of a commodity says that he sells it by such amount if the payment is on the spot and by such (excess) amount if the payment is after a certain time". See, FSC (1995, p173).

4 Indeed, most critics argue that the mark-up based asset management strategies of Islamic banks make the mark-up prone to becoming a fixed return on pure finance. See, ibid.

5 This extremely useful premises of partitioning total risk is laid down by Sharpe (1964) and Treynor (1965) in their models of pricing capital assets under conditions of risk.

6 See, Evans and Archer (1968).

7A thorough discussion of the model can be read from any standard text book on corporate finance and investments. For a text book comparison of this model with other models one can refer to Kelly, Frank K. (1989), *Investment Analysis and Portfolio Management,* London: Hourcourt Brace Jovanovich.

V
CHALLENGES OF MODARABA COMPANIES

The preceding discussion highlights that in a short period of time MCos., have expanded fast and acquired substantial market significance. This can be attributed among other things to wide scale ideological preference accorded to this sector by the investors. MCos., however, do not perform well compared to. other sectors particularly, leasing and investment banks which are registered as non-banking financial institutions and treated to a large extent similarly by the SBP. In the present section, some of the peculiar problems of MCos., are briefly discussed.

5.1 SALIENT FEATURES OF MODARABA COMPANIES

The challenges confronted by the MCos., can be better understood in the light of their peculiarities. The following salient features of MCos., may be recapitulated.

1. MCos., have found the stock market inevitable for their existence. There has been no example of *Modaraba* company, big or small, which may have started operations without being listed. It is unique characteristic of MCos., to open to stock market competition without any prior experience of business.
2. MCos., are almost 100% equity financed. Due to non-availability of appropriate financial instruments, these are incapacitate of mobilizing *Modarabas* other than the MCs and initial contribution o the paid-up capital by the sponsors.
3. Due to the second feature, MCos., have to overwhelming rely on distributing stock bonuses for saving cash.
4. Again, due to the second feature, for mobilizing *Modarabas,* MCos., overwhelmingly rely on rights issues.
5. Many MCos., are registered as leasing MCos., which have to have at least Rs.100 million paid up capital. As leasing institutions, 70% of their *Modarabas* must be kept in leasing operations. Due to constraints on cash flows capital replacement is restricted. Depreciation of assets overtime, leads to the depreciation in the prices of MCs.

6. Leasing MCos., are also competing with LCos., and leasing operations of commercial banks. Unlike MCos., the latter group of organizations have an access to local as well as international long-term credit lines.
7. MCos., have to distribute all profits as dividends. These cannot retain profits. Due to cash flow problems, distribution has mostly been in form of stocks dividends.
8. MCos., have to build a cash reserve with the State Bank of Pakistan equivalent to their paid-up capital. This reserve is built by a 20% contribution out of annual profits till the reserve is fully built. Thereafter, they have to contribute 5% of annual profits for the preservation of this *Modaraba.* According to new regulations, they can issue bonus shares only against this reserve. This regulations is considered to constrain the cash flow as well as dividend distribution by MCos.
9. Investors are understood to consider MCos., as a form of non-conventional business. The collapse of finance companies, and cooperatives which were somehow not similar to conventional financial institutions, has created a confidence problem for MCos., too.
10. Initially, MCos., were tax exempt provided they paid 90% of profits in dividends; 10% is paid to the management company as *mudharib's* share prescribed in the law. This tax benefit prompted many established companies to float MCos. The more novice MCos., are in fact competing with these matured institutions.
11. At the present, MCos., are paying taxes on earnings in the following form: First 3 years no taxes, following 2 years 12.5% and after 5 years of listing 25%. In addition, for leasing business, capital depreciation is adjusted in rentals for tax exemption.
12. Total 15% of liabilities must be invested in the shares of National Investment Trust (NIT Units).
13. Current assets/current liabilities ratio must be maintained at 1:1.
14. Equity/leveraged ratio must not exceed the 1:7 for first 2 years, and 1:10 ratio thereafter.
15. MCos., are over-regulated by the SBP, CLA, Registrar of MCos., RSB, Monopoly Control Authority, Controller of Corporate Issues, Stock Market authorities and Tax officials.
16. A consensus is emerging that MCos., have over-spread.
17. MC-holders have no voting rights; thus common stocks-holders have a preference over the MCs.

18. MC-holders do not enjoy the preferential treatment which holders of preference share do as a reward for not voting.
19. *Modaraba* firms are intensive in physical capital. MCs are issued against these physical assets. The value of the MCs basically depends on the value of these assets. The assets depreciate overtime. Asset replacement by means of profit retention or borrowing is not common. Naturally, therefore, the price of MCs must depreciate in proportion to depreciation of the assets.
20. MCos., have no R&D investments. These investments, e.g., in the chemical and pharmaceutical firms enable them to acquire value and capital gains overtime.
21. MCos., do not produce commodities. Improvement is product designs and other innovations add value to the firm and improve capital gains, e.g., in the electronic and engineering sector.
22. MCos., have not been able to spread their activities, e.g., like the banking sector. Banking services are wide spread and banks are able to continuously improve their services by the use of modern technology which adds to the value of the industry and capital gains for investors.
23. Most MCos., indigenous have abruptly exposed to stiff competition in an widely open economy. Compared to this, most other companies of the KSE were protected and subsidized in their infancy.
24. The above is a short list of the unique characteristics of MCos. These pose challenges to the future development of these Islamic enterprises. Thorough investigation of these and similar other considerations such as negligence of growth financing could be highly useful to understand the observed phenomenon regarding MCos., and to guide policies to alleviate some of their problems.

5.2 SALIENT POLICIES OF MODARABA COMPANIES

The above is a short list of the unique characteristics of MCos. These pose challenges to the future development of these Islamic enterprises. Thorough investigation of these and similar other considerations such as negligence of growth financing could be highly useful to understand the observed phenomenon regarding MCos., and to guide policies to alleviate some of their problems. For many limitations, such a comprehensive treatment of the subject is not feasible in the present
paper. In the following we will concentrate, in more detail, only on : a)

excessive reliance on rights issues, b) excessive reliance on stock dividends and c) consequences of constraining the dividend and financing policy of MCos.

Scope of Rights Issues

When a firm needs more *Modarabas* it resorts to various options - various forms of debts, various forms of equities and various forms of "dequities" (quasi-equities). For additional *Modarabas,* MCos., are relying only on equities. The three prominent forms of raising additional equity are: a) selling new stocks to the public (public offering) through firm commitment underwriters, b) issuing rights to holders of existing stocks with insurance to purchase the non-subscribed stocks by standby underwriters and c) uninsured rights issues to holders of existing stock on pro rata basis'.

As opposed to public offering (PO), rights offering (RO) is an offering of additional stocks to existing stock holders in proportion. to their holding. Thus rights issue allows the selling of additional stocks while maintaining the ownership proportion of the firm intact. In addition, it is beneficial for firms whose stocks are kept in blocks by few interest groups and the firms are not much known to the general investors. ROs., are also considered to be concessional sale of stock thus some form of bonus. Moreover, ROs., are considered to be much less costlier compared to POs. As the prices of the stock will generally fall after new issues, in POs., the new owners benefit at the expense of the old owners. In ROs., this is completely avoided.

In general, POs., are very common compared to ROs., particularly in the US. Companies in Europe and Canada are known to use ROs., too. In Pakistan, POs., are common in general. However, MCos., entirely rely on ROs., for mobilizing additional equity.

The RO., by MCos., works in the following general form. Assuming the price (market value) of an MC., of a particular *Modaraba is* Rs.30 on 31.5.1995. An investor holds 12 MCs., on that date. The *Modaraba* needs to mobilize more equity. The management decides that for each 6 MCs., held by investors one right will be offered. Each right can be converted into one MC., at a price of Rs.27 instead of Rs.30 provided the option of conversion is utilized by the owner of the existing MCs., by 22-6-1995.

Existing MC-holders are owners of the right to purchase the new MCs., at Rs.27, during the specified period subject to the number of MCs., already held by them. If they do not want to subscribe to new MCs., they can sell these rights to other investors. In this particular example, each right apparently offers a bonus of Rs.3. By selling this right for any positive amount the owner will benefit. Thus most MC., owners who are in need of cash will sell their rights. But they have to act fast; the subscription period is usually short, the offer can lapse.

Some indeed lapse. Since ROs., involve cost for the firm, the firm likes all ROs., must be utilized. To ensure this, the subscription price is kept low, over-subscription privilege is given to MC-holders and sometimes standby underwriting (a formal commitment with an underwriter to buy the unsubscribed MCs) is ensured.

When new capital is required, MCos., have the only choice between POs., and ROs. It is generally known that share prices decline after each PO. Thus, although, the company benefits from POs., in case of price decline as a result of a PO., the senior stock-holders shall loose. Their net wealth is transferred to the new share-holders. This problem is avoided by ROs., as new stocks will be bought by senior stock-holders and wealth transfer does not take place.

It should however, be noted that if ROs., are used by senior stock-holders, the wealth transfer will not take place. Many ROs., are indeed not used by senior stock-holders. Some are used as over-subscription rights by other investors and underwriters. As ROs., are meant to issue new stocks, stock prices are bound to decline after these are issued. Thus, theoretically, the problem of wealth transfer cannot be avoided by ROs., either. This is to indicate that in the interest of senior owners, both POs., and ROs., need to be issued carefully. A constant increase in ROs., associated with a constant decrease in the prices of MCs., indicates that things have gone wrong in conformity with the theory and against the interests of senior owners of MCs.

The above cannot be acceptable from the *Shari 'ah* point of view. ROs., are however, useful in maintaining the proportional ownership structure of the company. This can be seen as consistent with the pure *mudharabah* principle of not diluting the ownership structure with old and new owners..

Limitations of Stock Dividends

MCos., predominantly depend on distributing stock dividends. A minority of them distribute cash dividends. Only a few distribute both. The over reliance on stock dividends is often related to the cash flow problems of the companies. By distributing stocks, the companies save cash for some other urgent uses. Stock dividends are distributed in proportion to the already held MC., shares by investors.

In general, investors prefer cash dividends over stock dividends. This is because, in fact, stock dividends, merely "divide the pie into smaller slices". If a 20% stock dividends is issued, an investor holding 5 shares will get an additional one. The increase in the number of shares will put a down ward pressure on share prices. Given total earning the same, an increase in the number of shares will simply lead to a proportionate decrease in earning per share. Investors will be well-off, only if an increase in stock dividend is associated with an increase in the total earnings of the company, EPS and cash dividends.

Stock dividends, are thus good for companies whose share prices are increasing rapidly and which desire to check this increase to keep an optimal price level. This objective is, however, more directly achieved by stock splits; an over-priced stock, for example, is divided into two, so that an optimal price structure can be maintained.

As the prices of MCs., are already much weaker compared to the share prices in general, stock dividends can only put further downward pressure on the MC prices. This coupled with ROs., which are also expected to suppress MC., prices, provide enough explanation for the MCs., to constantly loose value.

To assist the prices of the MCs., MCos., in fact need to adopt MC., re-purchase plans rather than stock dividends and ROs. This option is however difficult, because most MCos., are already short of cash. Another possible option is to resort to reverse split. MCs., are grossly under-priced. To bring these prices closer to certain optimal level, MCs., can be withdrawn, and instead of 3 MCs., for example, one MC., can be issued. If the price of one MC., is Rs. 10, instead of 3 MCs., being kept, one MC., of Rs.30 can be kept by an investor. This proposal at this stage should be treated a mere idea. This crucial area indeed requires a separate study.

Consequences of Constrained Policies

MCos., are unique in the sense that these companies can neither device their financial policy independently nor their dividend policy. Their financing policy is constrained by non-availability of diversified financial instruments for resource mobilization. They are virtually dependent on one instrument: the MC. Reliance on one type of financial instrument could have been fair, provided it was the same for all market participant. All the non-Modaraba sector has the choice to utilize the over 30 instruments available. Obviously, therefore, this constrain is reflected through the market on the depreciating prices of the MCs.

Similar is the case with the dividend policy. Compared to other companies, MCos., are not free in deciding between how much to retain and how much to pay in dividends. In fact, the concept of retention of profits in the *Modaraba* business has not yet been thoroughly discussed.

Working together, these two factors impose a severe constrain on the policy of growth 'financing by the MCos., as compared to other companies. As a mater of fact, it seems that MCos., have no growth financing policies. For ongoing firms growth financing is an important source of continuity and dynamism.

NOTES

[1] It is reported that over the 1933-55 period, 50% of new issues worth $ 1 million and more were raised by ROs. By 1963-81, this reduced to from to 5% i.e., 95% of new • issues came through firm commitment arrangements. In Canada, 50%, in Europe lose to that level but actually declining in amount, is the share of ROs. This is despite the fact that ROs are much cheaper and convenient compared to POs. See, Smith (1978).

VI

CONCLUSIONS AND IMPLICATIONS

The emergence and market significance of the MCos., can be cited as an important outcome of the efforts made at the Islamization of the Pakistani economy. This experience is of general relevance for expanding the contemporary practice of Islamic financing particularly, in the non-banking financial sector. The MCos., with initial success have however, confronted some problems in growing, gaining value and improving the wealth of investors. In terms of a number of indicators, e.g., market valuation ratio and risk adjusted return, at the present, their performance in general, is found to be bellow the KSE average. An analysis of this phenomenon is useful in understanding and alleviating the problems confronted by the MCos. The present paper dealt with these considerations and identified several reasons for the low performance of MCos. Some of the reasons discussed in the paper are critically re-capitulated in the following:

1. It can be suggested that an over reliance on the stock markets is the origin of most problems confronted by the MCos. There has been no example of an unlisted *Modaraba.* Compared to this, most conventional companies, as well as LCos., start business as unlisted companies and get listed after attaining certain level of operational maturity. An infant MCo., exposed to stiff market competition with matured companies cannot be expected to be in a competitive position.

2. The ease in listing conditions has caused a premature over-spread of the *Modaraba* sector. The capital requirements for establishing a MCo., is very low; Rs. 5 to 7 million paid-up capital compared to Rs.100 million for the LCos. So, instead of establishing one LCo, with the same capital, 20 MCos., can be established! However, it must be noted that an average size of a MCo., is larger than a LCo., but, some MCos., are really small.

3. From investors' perspective, the numerical over-growth of MCos., resemble them with the collapsed cooperative and finance companies.

As a matter of fact, the performance of MCos., has sharply declined after the collapse of the cooperatives and the investment activities of some other companies (notably, the Taj Company) which were somehow linked to Islamic sentiments. This unwarranted fear on the part of the public has however, motivated the CLA, Registrar MCos., and the SBP to increase their regulatory activities.

4. Initially, the *Modaraba* business was encouraged by the government through fiscal incentives. Companies paying 90% of profits in dividends were exempted from the payment of corporate income tax (it shall be re-called that the remaining 10% of the profits is the fee of the manager of the *Modaraba).* This implies that the tax encouraged dividend distribution at the expense of retention and re-investment. There are ' strong theoretical arguments backed by empirical research that retention and re-investment of profits has a positive implication for the future growth and acquisition of value (capital gains) by the firm. This argument may not be complete. But, in view of the lack of acquisition of value by the MCos., further exploration of the argument and designing conscious dividend policies seams to be in the interest of the MCos.

   This crucial point may be clarified further with the help of an example. True, profit retention is not a feature of the traditional *mudharabah.* Probably, for this reason, the law does not encourage MCos., to retain and re-invest profits. Since retention and re-investment of profits enhances the growth of a firm and its value over time, MCos., not retaining any fraction of the profits, practically do not pursue any forceful growth strategy. This is certainly reflected in the depressed prices of the MCs.

   Compared to this, we can consider a firm whose dividends are taxed and capital gains are not. Such a firm would have an incentive to maximize its retention for growth financing which would enhance its value and capital gains. In the longer-run perspective, the race would likely be won by the firm which retains and re-invests. If the firm faces cash flow problems, like most MCos., retention becomes even more urging. Certainly, there are economic arguments for and against dividend payments. These arguments, all relate to the decision on the degree of dividends vis-a-vis retention. There is no case to my notice, where an economic argument may have been made for zero retention, particularly, by a firm facing cash flow problems.

5. The initial tax incentive was withdrawn by the government brining the MCos., at par with other non-banking financial institutions. The government instead, introduced a tax incentive to encourage the leasing sector. Accordingly, 30% of rental expenses are made eligible for corporate income tax deductions. This naturally left the expectations of those MCos., which were established under the old tax structure unfulfilled. It is observed that some companies, which were not having any genuine interest in *Modaraba,* but were only benefiting from the tax shield for raising cheaper funds for their ongoing businesses had to adjust themselves. This sent an adverse signal to the investors and contributed to the weakening of demand for MCs.

6. MCos., are short of liquidity. They have to build a reserve with the SBP. They do not have recourse to any long-term credit lines and do not have any source to raise short-term funds. MCs., are the only source of their funds. Thus, the MCos., rely only on rights issues for resource mobilization and pay stock bonuses to save cash. Rights issues and stock bonuses, both put a downward pressure on the price of MCs., by simply increasing the number of MCs., in circulation. In addition, if the investor is in need of cash, neither rights issues nor stock bonuses can meet his requirements. The long-term consequences of this is the fall in trading reflected in the MVR and prices of the MCs.

7. Compared to the MCos., LCos., and investment banks are in a comparative advantage as far resource mobilization is concerned as these can utilize all forms of conventional instruments. Thus MCos., are under tremendous pressure as for the availability of funds are concerned. The most serious problem confronted by the MCos., is the mobilization of diversified forms of funds suitable for different uses, particularly, growth financing. No single financial instrument can bring the facility for MCos., at par with the financing facilities available to conventional companies and leasing 'sector.

Nevertheless, a common characteristic of all possible instruments would be redeemability as compared to the non-redeemability of the MCos. In this regard, recently the religious board has approved two different arrangements, namely, redeemable *Musharakah* certificates for using in the local market and redeemable income certificates for dealing with the international investors particularly, the International Finance Corporation. These facilities will no doubt improve the cash flow of the companies, but these are in no sense comparable to the sophisticated facilities available to other competing sectors.

8. Our analysis has pointed out the relative vulnerability of MCos., vis-a-vis competing sectors such as LCos., and investment banks in the KSE. The reality that Islamic financial institutions will have to show their viability in a mixed environment competing with interest-based financial institutions need to be accepted. No single country, a single market or a single sector can survive in isolation from the rest of the world and the global market and other sectors of the economy. It therefore implies that the MCos., and similar other Islamic financial institutions must be equipped with appropriate financial instruments to confront, rather than escape the phenomenon of "globalization of financial markets". Ideological compromises on the acceptability of interest is not possible. Given this premises, it need to be kept in sight that there are over 30 interest-based financial instruments available, e.g., to the LCos. None of these are available to the MCos., - the MCos., have so far relied on one instrument only, the MCs!.

9. Even the MCs., cannot be considered superior assets compared to common and preference stocks of the more matured companies of the KSE. The MCs., simultaneously resemble common and preference shares. These are similar to common stocks as far entitlement to return is concerned, but similar to preference shares as the owners cannot interfere in the management of the company - MC-holders do not have voting rights. In this form, MCs., are inferior assets compared to common stocks, as MC., owners unlike owners of common stock do not have any control on the company's management. MCs., are inferior assets compared to preference shares due to the fact that preference share holders have preference over common share holders in entitlement to return. So, if investors have to decide between MCs.,

and common stocks or preference shares of conventional companies, both of the latter two will be preferred.

It can be argued that preference shares would be eliminated from the list of investment opportunities for Islamic reasons. Similarly, common stock of companies which do not observe the *shari'ah* fully, e.g., which have interest in their capital structure are also eliminated from the list of Islamic investment opportunities. These are important considerations to strengthen the demand for MCs. But it should also be noted that despite these considerations, common stock of many conventional companies are close substitute to the MCs. Moreover, in order to gain value, the MCs., have to attract a wide spectrum of investors which may not necessarily be conscious of the Islamic requirements. Such investors will simply look at the fact that by investing in the MCs., they will forego their voting rights without any benefits of the preference shares!

The Most important implication of our analysis is therefore, to evolve interest-free substitutes to the several instruments available in the market including common and preference stocks. The introduction of *Musharakah* Certificates by some MCos., is a step in the right direction. *Musharakah* certificates will be at par with common stock in the sense that these will also entitle the owners to direct the management by using their voting rights. The result of this instrument is yet to be seen. The willingness of the IFC to deal with the MCos., with *Musharakah* Certificates instead of MCs., is a clear indication of the superiority of the new instrument.

If the function of the conventional common stock is taken over by the *Musharakah* certificates, the function of preference shares will naturally be left over for the MCs. But to be at par with the preference shares, the MCs., must be competitive in terms of return. The immediate concern is therefore, how to compensate the MC., owners for foregoing the voting rights which they can enjoy by investing in *Musharakah* certificates or common stocks of other companies? In other words, why should investors invest in MCs., if they can enjoy voting and control rights by investing in *Musharakah* certificates and common stock? Unless, there is financial rationale from the investor's perspective, in the final analysis, MCs., will be considered inferior assets compared to *Musharakah* certificates; ultimately, MCs.; will vanish and only *Musharakah* certificates will prevail. Given this trend the MCos., must be relieved from the crippling limitations of a solitary instrument, be it *a Mudharabah* or *Musharakah* Certificate.

It may be argued that not all investors are in a position and interested to participate in management by voting, e.g., the owner of *Modarabas* of the traditional *mudharabah.* We should however, keep three considerations in view: a) technology has made voting feasible for every investor; by using electronic mail, by the so-called process of "cybercasting", voting rights can always be utilized, b) it is not necessary that each voter should vote; the possibility that each voter may vote works as a control mechanism on the management and c) most institutional investors, e.g., the IFC mentioned above prefer to have a say in the management of the MCos. Therefore, the issue at hand is not of introducing one more instrument. The challenge in fact is related to the evolution of a comprehensive system of shari'ah-based financial instruments.

10. Regarding the evolution of a comprehensive system of Islamic financial instruments, it is essential to understand the functions of the conventional instruments available, e.g., in the KSE, and how these functions can be taken over by different Islamic instruments. Most of these instruments have evolved over a period of time. Therefore, we can expect the evolution of alternative Islamic instruments over a period of time too.

Many efforts are underway to overcome the difficulties of *shari'ah* observing institutions related to the availability of financial instruments for resource mobilization. Some good ideas relate to securitization of leasing', and installment sale which if approved by the *shari'ah* scholars may offer permissible, yet secured return to investors; some form of equity-debt hybrids ("dequities"), which if accepted by shari 'ah scholars' may offer alternative to preferred stocks[2]. Moreover, redeemable Islamic instruments are needed to take over the redeemability function of debt instruments. Financial instruments which can be redeemed without violating the *shari 'ah* requirements are urgently needed by the MCos., to improve their cash flow and enable them to compete in the market.

The availability of various types of instruments will enable the MCos., to design appropriate financing as well as dividend strategies. Within the framework of prohibition of *riba,* the MCos., should be. independent to design these strategies, particularly, when they have to compete with firms which have the relative if not absolute freedom to do so.

Finally, a warning is in order and some expectations may be raised. This research has several limitations. Despite that, I consider, this research deals with an important, yet grossly ignored area - corporate practices of Islamic financial institutions. Although the paper deals with one market - the KSE, the general conclusions and implications of the research may be of some use in understanding certain aspects of Islamic corporate financing practices in a mixed environment. There are many issues which require research in the area of Islamic corporate finance. For instance, with the rich data available for some markets in the Muslim countries, the theory of Islamic financing can be put into an empirical perspective. To avoid being trapped in self deception, such research should be based on critical assessment of the problems and challenges in the application of the Islamic principles of finance, and to suggest ways and means to alleviate these problems. This paper is a humble *effort* in this regard.

NOTES

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1 See, for example, Kahf, (1994)
2 See, for example, Khan (1995).

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APPENDIX 1

THE *MODARABA* LAW

REGISTERED NO. M-302
L-7646

THE GAZETTE OF PAKISTAN
Extra Ordinary
Published by Authority

ISLAMABAD, THURSDAY, JUNE 26, 1980

ACTS, ORDINANCES, PRESIDENT'S ORDERS AND REGULATIONS INCLUDING MARTIAL LAW ORDERS AND REGULATIONS

GOVERNMENT OF PAKISTAN
MINISTRY OF LAW AND PARLIAMENTARY AFFAIRS
(Law Division)

Islamabad, the 26th June 1980

No. F. 17(1)/80-Pub. - The following Ordinance made by the President on the 26th June 1980 are hereby published for general information:-

ORDINANCE XXXI OF 1980
AN
ORDINANCE

to provide for matters relating to registration of *Modaraba* companies and the floatation, management and regulation of *Modarabas*.

WHEREAS it is expedient to provide for matters relating to registration of *Modaraba* companies and the floatation, management and regulation of *Modarabas* and for matters connected therewith or ancillary thereto:

AND WHEREAS the President is satisfied that circumstances exist which render it necessary to take immediate action:

NOW, THEREFORE, in pursuance of the Proclamation of the fifth day of July 1977, read with the Laws (Continuance in Force) Order, 1977 (C. M. L. A. Order No. I of 1977), and in exercise of all powers enabling him in that behalf, the President is pleased to make and promulgate the following Ordinance:

PART I

PRELIMINARY

1. Short title, extent and commencement:

(1) This Ordinance shall be called the *Modaraba* Companies and *Modaraba* (Floatation and Control) Ordinance, 1980.
(2) It extends to the whole of Pakistan.
(3) It shall come into force at once.

2. **Definition**

(1) In this Ordinance, unless there is any thing repugnant in the subject or context, -

(a) *"Modaraba"* means a business in which a person participates with his money and another with his efforts or skill or both his efforts and skill and shall include Unit Trusts and Mutual Funds by whatever name called;
(b) "*Modaraba* Certificate" means a certificate of definite denomination issued to the subscriber of the *Modaraba* acknowledging receipt of money subscribed by him;
(c) "*Modaraba* company" means a company engaged in the business of floating and managing *Modaraba;*

(d) "*Modaraba* Fund" means a fund raised through floatation of *Modaraba;*
(e) "prescribed" means prescribed by rules;
(f) "Registrar" means the Registrar appointed under section 3;
(g) "rules" means rules made under this Ordinance; and
(h) "Tribunal"-means a Tribunal constituted under section 24.

(2) All terms and expressions used but not defined in this Ordinance shall have the same meaning as in Companies Act, 1913 (VII of 1913).

3. **Appointment of Registrar -** The Federal Government may, by notification in the Official Gazette, appoint a person to be the Registrar for the purpose of this Ordinance.

PART II

REGISTRATION OF *MODARABA* COMPANIES

4. **No company to operate without registration -** No *Modaraba* company shall operate without registration with the Registrar.

5. Eligibility for registration:

(1) A company shall be eligible for registration as *a Modaraba* company if it fulfills the following conditions, namely:

(a) that it is registered under the Companies Act, 1913 (VII of 1913) or is a body corporate formed under any law in force and owned or controlled, whether directly or through a company or corporation, by the Federal Government or a Provincial Government:
(b) that, being a company solely engaged in the floatation and management of *Modaraba,* it has a paid up capital of not less than two and a half million rupees:
(c) that none of its directors, officers or employees has been convicted of fraud or breach of trust or of an offense involving moral turpitude:

(d) that none of its directors, officers or employees has been adjudged an insolvent or has suspended payment or has compounded with his creditors:

(e) that its promoters are, in the opinion of the Registrar, persons of means and integrity and have knowledge of matters which the company may have to deal with as *a Modaraba* company: and

(f) that, being a company also engaged in business other than floatation and management of *Modaraba,* it has a paid up capital of such amount and of such nature as may be prescribed.

6. Application for registration

(1) A company which is eligible for registration as a *Modaraba* company may make an application for registration to the Registrar in such form and with such documents as he may be prescribed.

(2) The Registrar, if he is satisfied after such inquiry and after obtaining such further information as he may consider necessary that the applicant is eligible for registration and that it is in the public interest so to do, may grant registration to such company on such conditions as he may deem fit.

3) In particular and without prejudice to the generality of the powers conferred by sub-section (2), such conditions may include -

(i) investments to be made;
(ii) information to be made;
(iii) business to be undertaken, and
(iv) restriction on transfer of shares by promoters, sponsors or persons holding controlling interest.

PART III

PROVISIONS APPLICABLE TO *MODARABAS*

7. **Types of *Modaraba* -** (1) *Modaraba* may be of two descriptions -

(i) Multipurpose *Modaraba* - That is to say *a Modaraba* having more than one specific purpose or objective.

(ii) Specific purpose *Modaraba* - That is to say *a Modaraba* having one specific purpose or objective.

(2) *A Modaraba* may be either for a fixed period or for an indefinite period.

8. **Creation and maintenance of *Modaraba* -** (1) A *Modaraba* company registered under section 4 shall apply to the Registrar in such form

and with such documents as may be prescribed for permission to float *Modaraba.*

(2) An application for floatation of *Modaraba* shall be accompanied by a prospectus which shall contain, inter alia, the following information, namely -

(i) the name and type of the *Modaraba;*
(ii) the conditions and amounts of the *Modaraba* to be floated and the division thereof into *Modaraba* Certificates of fixed amount;
(ii) the business scheme, prospectus and mode of distribution of profit;
(iv) the amount to be subscribed by the *Modaraba* company to the *Modaraba* in its own name supported by evidence about its ability to meet the commitment;
(v) the form of the *Modaraba* Certificate; and
(vi) such other matters as may be prescribed.

(3) The application, the prospectus and the documents filed therewith shall be authenticated by all the directors of the company.

9. **Religious Board -** The Federal Government shall, for the purpose of this Ordinance, constitute a Religious Board which shall consist of such members and shall have such functions, terms and conditions as may be prescribed.

10. **Business of *Modaraba* -** No *Modaraba* shall be a business which is opposed to the injunctions of Islam and the Registrar shall not permit the floatation of *a Modaraba* unless the Religious Board has certified in writing that the *Modaraba* is not a business opposed to the injunctions of Islam.

11. **Authorization -** The Registrar may, after obtaining from the Religious Board a certificate to the effect mentioned in section 10 and on being satisfied that it is in the public interest so to do, grant a certificate in the prescribed form authorizing the floatation of *Modaraba* on such conditions as he may deem fit, including conditions as to the business to be undertaken, expenses relating to the management of the *Modaraba* Fund, preservation of assets and other matters relating to the mode of management and distribution of profits:

Provided that, before issuing the certificate of authorization, the Registrar may require the *Modaraba* company to make such modifications, additions or omissions in the prospectus as the Religious Board may have indicated or as he may deem fit.

12. ***Modaraba* to be a legal person**

(1) A *Modaraba* shall sue and be sued in its own name through the *Modaraba* company.

(2) The assets and liabilities of each *Modaraba* shall be separate and distinct from those of another *Modaraba* as also from those of the *Modaraba* company.

13. Conditions applicable to *Modaraba*

(1) No allotment of *Modaraba* Certificates shall be made unless a prospectus approved by the Registrar has been issued and the minimum amount stated in the prospectus to be the amount which must be raised in order to provide for the business operations and expenses has been subscribed.

(2) All moneys received from the applicants for *Modaraba* Certificates for *a Modaraba* shall be deposited and kept in a separate account in a scheduled bank as defined in the State Bank of Pakistan Act, 1956 (II of 1956) until they are refunded in accordance with the provisions of sub-section (3) or until it is certified by the Registrar that *Modaraba* Certificates have been allotted in an amount not less than the minimum amount referred to in sub-section (1).

(3) If the subscription referred to in sub-section (1) has not been received by the date specified in the prospectus, all moneys received from the applicants shall be refunded to them within fifteen days of the said date and the *Modaraba* company and the directors thereof shall be jointly and severally liable to repay the money which is not so refunded.

(4) The *Modaraba* company shall issue *Modaraba* Certificates within thirty days from the date of allotment.

(5) The *Modaraba* company shall maintain a register of holders of *Modaraba* Certificates in such form and in such manner as may be prescribed.

(6) The *Modaraba* company shall maintain separate bank account, funds, assets and liabilities of each *Modaraba.*

(7) No *Modaraba* shall be liable for the liabilities, or be entitled to benefit from the assets, *of any* other *Modaraba or* of the *Modaraba* company;

(8) *A Modaraba* Certificate shall be transferable in the manner provided for in the prospectus of the *Modaraba.*

14. **Preparation and circulation of annual accounts, reports, etc. -** (1) The *Modaraba* company shall, within six months from the close of the accounting year of the *Modaraba,* prepare and circulate to the holders of *Modaraba* certificates -

annual balance sheet and profit and loss account in such form and manner as may be prescribed;
a report of the auditor on the balance sheet and profit and loss account;

(iii) a report by the *Modaraba* company on the state of affairs, activities and business prospects of the *Modaraba* and the amount of profits to be distributed to the certificate holders.

(2) In addition to the documents referred to in sub-section (1) the *Modaraba* company shall furnish to the Registrar and to the holders of the *Modaraba* Certificates such reports, accounts and information as may be prescribed or as the Registrar may, at any time by an order in writing, require.

(3) The *Modaraba* company shall submit five copies of the accounts, statements and reports referred to in sub-sections (1) and (2) to the Registrar simultaneously with the circulation of these documents to the holders of *Modaraba* Certificates.

15. Audit of accounts - (1) The accounts of a *Modaraba* shall be audited by an auditor who is a Chartered Accountant within the meaning of the Chartered Accountants Ordinance, 1961 (X of 1961), appointed by the *Modaraba* company with the approval of the Registrar and such auditor shall have the same powers, duties and liabilities as an auditor of a company has under the Companies Act, 1913 (VII of 1913), and such other powers, duties and liabilities as are, or may be, provided in this Ordinance and the rules.

(2) In addition to other matters, the auditors shall also state in his report whether in his opinion the business conducted investments made and expenditure incurred by the *Modaraba* are in accordance with the objects, terms and conditions of the *Modaraba.*

16. **Prohibition of false statement, etc. -** No *Modaraba* company, director, officer, employee or agent or auditor thereof shall, in any document, prospectus, report, return, accounts, information or explanation required to be furnished in pursuance of this Ordinance or the rules or in any application made under this Ordinance or the rules, make any statement or give any information which he knows or has reasonable cause to believe to be false or incorrect or omit any material fact therefrom.

17. **Conditions Applicable *to Modaraba Company***

(1) No *Modaraba* company shall engage in any business which is of the same nature and competes with the business carried on by *a Modaraba* floated or controlled by it.

(2) No *Modaraba* company or any of its directors or *officers* or their relatives shall obtain loan, advance or credit from the funds of the *Modaraba* or on the security of the assets of the *Modaraba.*

Explanation - In this sub-section, "relative", in relation to a director or officer, means the spouse, brother or sister or any of the lineal ascendants or descendants of the director or officer.

(3) A *Modaraba* company shall subscribe in each *Modaraba* floated by it not less than ten per cent of the total amount of *Modaraba* Certificates offered for subscription.

18. **Remuneration of *Modaraba* company -** The remuneration of a *Modaraba* company in respect of a *Modaraba* floated by it shall be a fixed percentage of the net annual profits of the *Modaraba* and shall not exceed ten per cent of such net annual profits computed in the manner to be prescribed.

19. Cancellation of Registration

(1) Where the Registrar is of the opinion that *a Modaraba* company has contravened or has failed to comply with any provision of this Ordinance of the rules or with any direction made or given thereunder, he may, if he considers necessary in the public interest so to do, by order in writing -

(a) cancel the registration of the *Modaraba* company; and
(b) remove the *Modaraba* company from the management of the *Modaraba* floated by it.

Provided that no such order shall be made without giving the *Modaraba* company an opportunity of being heard.

(2) The *Modaraba* company removed from the management of a *Modaraba* under clause (b) of sub-section (1) shall not be entitled to or be paid any compensation or damages for loss or termination of office.

(3) *A Modaraba* company removed from the management of a *Modaraba* under clause (b) of sub-section (1) shall not be entitled to float any *Modaraba.*

(4) *A Modaraba* company aggrieved by an order of the Registrar under sub-section (1) may prefer an appeal to the Federal Government within thirty days of the date of the order.

[I](5) An appeal preferred under sub-section (4) shall be disposed of by the Federal Government after giving the appellant an opportunity of being heard.

20. **Appointment of Administrator -** (1) If -

(a) the Registrar has reason to believe that *a Modaraba* company has been conducting the affairs of a *Modaraba* in a manner prejudicial to the interest of the *Modaraba* or the holders of *Modaraba* Certificate or in a fraudulent or unlawful manner or has committed a default in complying with the provisions of this Ordinance or the rules or with any direction made or given thereunder or any condition of the *Modaraba:*

(b) the registration of a *Modaraba* company has been canceled: or

(c) any other *Modaraba* under the management of the *Modaraba* company has been ordered to be wound up by the Tribunal.

The Registrar, after affording the *Modaraba* company an opportunity of being heard may, without prejudice to any other action under the law, by order in writing -

(i) appoint an administrator to take over and manage the *Modaraba* in place of the *Modaraba* company for such period as the Registrar may specify: or

(ii) require the *Modaraba* company to carry out such changes in the management and procedure as may be specified: or

(iii) remove the *Modaraba* company and appoint another *Modaraba* company in its place to manage the *Modaraba.*

I Added by Notification dated 27 July 1985 published in the Gazette of Pakistan, Extraordinary, Part-I (Act No. IV of 1985).

(2) The Registrar shall not make an order under sub-section (1) without the approval of the Federal Government.

21. **Inquiries**

(1) The Registrar may, on his own motion or an application made by the holders of *Modaraba* Certificates the value of which is not less than ten per cent of the total subscribed amount of the *Modaraba,* by an order in writing cause an inquiry to be made by a person appointed by him in this behalf into the affairs of a *Modaraba* company or the *Modaraba* or any business transaction thereof

(2) Where an inquiry under sub-section (1) has been ordered, every director, manager or other officer of the *Modaraba* company to which the inquiry relates and every other person who has had any dealing with such *Modaraba* company or director or officer shall furnish such information or document in his custody or power or within his knowledge relating to or having a bearing on the subject matter of the inquiry as the person conducting the inquiry may by notice in writing require.

(3) The person conducting an inquiry under sub-section (1) may for the purpose of such inquiry enter into any premises belonging to -or in occupation of the *Modaraba* company of the person to whom the inquiry relates and may call for, inspect and seize books of accounts and documents in possession of any such *Modaraba* company, director, manager or any other officer or employee thereof.

(4) The person holding an inquiry under sub-section (1) shall, for the purpose of such inquiry, have the same powers as are vested in a court under t he Code of Civil Procedure, 1908 (Act V of 1908), when trying a suit in respect of the following matters, namely -

(a) enforcing the attendance of a person and examining him on oath or affirmation.
(b) compelling the discovery and production of documents: and
(c) issuing commissions for the examination of witnesses.

(5) On receipt of the report of the person conducting the inquiry, the Registrar shall take such action as he may consider necessary on the basis of the report.

WINDING UP

22. **Circumstances in which *Modaraba* may be wound up voluntarily -** *(1) A Modaraba* floated' for a fixed period or for a specific purpose shall be wound up by the *Modaraba* company itself on the expiry of the period fixed for the *Modaraba* or the accomplishment of the purpose of the *Modaraba,* as the case may be, provided the following conditions are fulfilled, namely

(a) all the directors of the *Modaraba* company shall make a declaration verified by an affidavit to the effect that they have made a full inquiry about the affairs of the *Modaraba* and, having done so, have formed the opinion that the *Modaraba* will be able to discharge its liabilities, pay the amount subscribed by the holders of the *Modaraba* Certificates and all their other dues in full within a period of twelve rnonths from the date of the expiry of the period fixed for the *Modaraba* or the accomplishment of the purpose of the *Modaraba,* as the case may be.

(b) the declaration referred to in clause (a) shall be supported by a report of the auditor of the *Modaraba* on the affairs of the *Modaraba* and shall have no effect unless it is filed with and approved by the Registrar within ninety days of the date of expiry of the period fixed for the *Modaraba* or the accomplishment of the purpose of the *Modaraba,* as the case may be.

(2) Any person aggrieved by the decision of the Registrar under clause (b) of sub-section (1) may prefer an appeal to the Federal Government within thirty days of the day on which the decision is given.

[2](3) An appeal preferred under sub-section (2) shall be disposed of by the Federal Government after giving the applicant an opportunity of being heard.

23. **Circumstances in which *Modaraba* may be wound up by the Tribunal**

(1) *A Modaraba* shall be wound up by the Tribunal on an application made by the Registrar if -

(i) in the case of a *Modaraba* for a fixed period on the expiry of that period or, in the case of *a Modaraba* for a specific purpose on the accomplishment of its purpose, the declaration referred to in section 22 has not been filed with the Registrar within the period specified in that section;

(ii) in the case of any *Modaraba,* the Registrar has declared that

the *Modaraba* is unable to discharge its liabilities:

(a) the accumulated losses of the *Modaraba* exceed fifty per cent of the total amount subscribed by the holders of the *Modaraba* Certificates: or

(b) the business of the *Modaraba* is being or has been conducted for a fraudulent purpose or with intent to

(c) defraud the holders of the *Modaraba* Certificates, or its creditors or any other person:

(iii) the Tribunal is of opinion that it is just and equitable that the *Modaraba* should be wound up.

(2) The Registrar may make an application to the Tribunal for the winding up of *a Modaraba* on receipt of an application under sub-section (1) of section 21 or of the report of an inquiry under that section relating to the *Modaraba.*

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2 Added by Notification dated 27 July 1985 published in the Gazette of Pakistan, Extraordinary, Part-I (Act No. IV of 1985).

(3) No application shall be made by the Registrar under sub-section (1) or (2) without giving the *Modaraba* company an opportunity of being heard.

24. Constitution of Tribunal

(1) The Federal Government may, by notification in the Official Gazette, constitute one or more Tribunals for the purpose of this Ordinance and where it constitutes more than one Tribunal, shall specify in the notification the area within which, or the class of cases in respect of which, each such Tribunal shall exercise jurisdiction under this Ordinance.

(2) A Tribunal shall consist of a person who is, or has been, or is qualified to be a judge of a High Court.

25. Powers of a Tribunal

(1) A Tribunal shall:.

(a) in the exercise of its Civil Jurisdiction, have in respect of a claim filed by a holder of *Modaraba* Certificates against the *Modaraba* company or by *a Modaraba* company against any other party with whom it has entered into business transactions relating to *Modaraba* Fund, or in respect of an application by the Registrar for the winding up of a *Modaraba* company, all the powers vested in a civil court under the Code of Civil Procedure, 19808 (Act V of 1908):

(b) in the exercise of its criminal jurisdiction, try the offenses permissible under this Ordinance and shall, for that purpose, have the same powers as are vested in the Court of a Sessions Judge under the Code of Criminal Procedure, 1898 (Act V of 1898):

Provided that a Tribunal shall not take cognizance of any offense punishable under this Ordinance except on a complaint in writing made by the Registrar or an officer authorized by him in writing, and

(c) exercise and perform such other powers and functions as are, or may be, conferred upon or assigned to it by or under this Ordinance.

(2) All proceedings before a Tribunal shall be deemed to be judicial proceedings within the meaning of sections 193 and 228 of the Pakistan Penal Code (Act XLV of 1860), and the Tribunal shall be deemed to be a court for the purposes of sections 480 of the Code of Criminal Procedure 1898 (Act V of 1898).

(3) No court other than the Tribunal shall have or exercise any jurisdiction with respect to any matter to which the jurisdiction of the Tribunal extends under this Ordinance.

26. **Procedure of the Tribunal**

(1) Matters before the Tribunal shall come up for regular hearing as expeditiously as possible and, except in extraordinary circumstances and on grounds to be recorded, the Tribunal shall hear the cases from day to day.

(2) In the exercise of its civil jurisdiction, the Tribunal shall, in all suits before it, including suits for recovery of money, follow the summary procedure provided for in Order XXXVII of the First Schedule to the Code of Civil Procedure, 1908 (Act V of 1908).

27. **Powers of Tribunal on hearing application for winding up of *Modaraba***

(1) If, after hearing the application for winding up of *a Modaraba,* the Tribunal decides to wind up the same it shall appoint a liquidator in consultation with the Registrar and approve a general scheme of winding up.

(2) After a winding up order has been passed by the Tribunal, the *Modaraba* company shall forthwith hand over charge of the *Modaraba* to the liquidator and furnish him with such statements, records, information and other material as may be required by him.

(3) The liquidator shall conduct the winding up proceedings in the prescribed manner under the control and directions of the Tribunal.

(4) The winding up proceedings shall be completed within a period of one year from the date of appointment of the liquidator, unless the Tribunal, for special reasons to be recorded in writing, extends the period.

(5) During the winding up proceedings, the Tribunal may allow the administrator appointed by the Registrar under section 20, if any, to continue to function or may appoint an administrator to manage the *Modaraba* till the disposal of the proceedings.

28. **Judgment and decree**

(1) A Tribunal shall, after the case has been heard, pronounce judgment as early as practicable and on such judgment a decree shall follow forthwith.

(2) The Tribunal shall, on the application of the decree-holder, forthwith order execution of the decree:

Provided that, if the decree is for money, the recovery in execution thereof shall be made as arrears of land revenue.

29. **Finality of orders -** Subject to the provisions for appeal as provided in section 30, no court or other authority shall call or permit to be called in question any order, judgment or sentence of the Tribunal or the legality or propriety of any thing done or intended to be done by the Tribunal under this Ordinance.

30. **Appeals**

(1) Any person aggrieved by any order, judgment, decree or sentence of the Tribunal may, within thirty days of such order, judgment, decree or sentence, prefer an appeal to the High Court within whose jurisdiction the order, judgment, decree or sentence is passed :

Provided that no appeal shall lie from an interlocutory order which does not dispose of the entire case before the Tribunal.

(2) An appeal under sub-section (1) shall be heard by a Bench of two judges of the High Court and shall lie on any one of the following grounds, namely

(a) the decision being contrary to law or to some usage having the force of law; or
(b) the decision having failed to determine a material issue of law or usage having the force of law; or
(c) a substantial error apparent in the procedure provided by or under this Ordinance, which may possibly have led to an error in the decision.

(3) An appeal may be preferred under this section from a. decision made ex-parte.

31. **Punishment**

(1) Whoever contravenes the provisions of section 4, 10, 13, 14, 16 or 17, shall be punishable with imprisonment of either description for a term which may extend to three years and with fine which may extend to five hundred thousand rupees.

(2) Where the contravention referred to in sub-section (1) has caused loss to the ***Modaraba*** or any other person, a further fine to the extent of the loss shall be imposed.

32. **Penalty -** If any person

(a) refuses or fails to furnish any document, return or information which is required to furnish by or under this Ordinance : or
(b) refuses or fails to comply with any condition imposed or made by the Federal Government or direction made or given under this Ordinance or the rules : or
(c) contravenes or otherwise fails to comply with any provision of this Ordinance or the rules other than those referred to in sub-section (1) of section 31.

The Registrar may, if he is satisfied, after giving the person an opportunity of being heard, that the refusal, failure or contravention was willful, by order, direct that such personal shall pay to the Federal Government by way of penalty such sum not exceeding one hundred thousand rupees as may be specified in the order and, in the case of a continuing default, a further sum calculated at a rate not exceeding one thousand rupees for every day after the issue of such order during which the refusal, failure or contravention continues.

33. **Liability of director, manager or officer of a company**

(1) Where the person guilty of an offense referred to in sub-section (1) of section 31 or in section 32 is a company or other body corporate, every director, manager, or other officer responsible for the conduct of its affairs shall, unless he proves that the offense was committed without his knowledge, or that he exercised all diligence to prevent its commission, be deemed to be guilty of the offense.

(2) Any sum directed to be paid under section 32 shall be recoverable as an arrears of land revenue.

(3) No prosecution for an offense against this' Ordinance or the rules shall be instituted in respect of the same facts on which a penalty has been imposed under section 32.

34. **Powers of the Registrar in relation to certain Proceedings -** In any proceedings under section 32, the Registrar shall have the same powers as are vested in a court under the Code of Civil Procedure, 1980 (Act V of 1908), when trying a suit in respect of the following matters, namely

(a) enforcing attendance of a person and examining him an oath or affirmation; and
(b) compelling the discovery and production of documents.

35. Application of fine - The Tribunal imposing any fine under may direct that the whole or any part thereof shall be applied in or towards -

(i) payment of costs of the proceedings;
(ii) payment to an aggrieved party of compensation for any loss

(iii) payment of compensation for any loss mentioned in sub-section (2) of section 31.

36. Enforcement of provisions of the Ordinance, etc.

(1) If *a Modaraba* company makes default in complying with any provisions of this Ordinance or a direction made or given under this Ordinance and fails to make good the default within thirty days of the service of a notice to the *Modaraba* company requiring it to do so, the Tribunal may, on an application made to the Tribunal by the Registrar, make an order directing the *Modaraba* company and any director or officer thereof to make good the default within such period as may be specified in the order.

(2) Nothing in this section shall be deemed to prejudice the operation of any provision of this Ordinance providing for the imposition of penalties on the *Modaraba* company or its directors and officers in respect of any such default as aforesaid.

37. **Exemption from tax -** The income of a *Modaraba* shall be exempt from tax under the Income Tax Ordinance, 1979 (XXXI of 1979), if not less than ninety per cent of its profits in a year is distributed to the holders of the *Modaraba* Certificates.

38. **Power of Federal Government to exempt, etc. -** The Federal Government may, by notification in the official Gazette, exempt from the requirements of sub-sections (1) and (3) of section 17 a company or a body corporate formed under any law and owned or controlled by the Federal Government or a Provincial Government, whether directly or through a company or corporation set up by such Government.

39. **Delegation of Powers -** The Registrar may, by notification in the official Gazette, delegate, subject to such limitations, restrictions or conditions, if any, as he may, from time to time specify, such of his powers and functions under this Ordinance as he may deem fit to any officer subordinate to him.

40. **Indemnity -** No suit, prosecution or other legal proceedings shall lie against the Federal Government or the Registrar or any other officer for any thing which is in good faith done or intended to be done under this Ordinance or any rules.

41. Power to make rules

(1) The Federal Government may, by notification in the official Gazette, make rules for carrying out the purpose of this Ordinance.
(2) In particular and without prejudice to the generality of the foregoing power, such rules may include

i. The duties and functions of the Registrar,
ii. Terms and conditions of a Triburial
iii. Procedure relating to a Tribunal
iv. Composition, terms and conditions of the Religious Board
v. Procedure relating to the conditions of the religious board,
vi. From, contents and other requirements of a prospectus,
vii. Issue and allotment of Modaraba Certificates,
viii. Maintenance of Modaraba accounts and funds,
ix. Form of balance sheet and profit and loss account,
x. Audit and auditor's certificate,
xi. Annual and periodical accounts and reports,
xii. Inspection of record and supply of copies of documents,
xiii. Matters relating to winding up,
xiv. Matters and procedures relating to inquiries,
xv. Charging and determination of fees payable under this Ordinance, and
xvi. Such other matters as are to be or may be prescribed.

42. **Act to override other laws** – The provisions of this Ordinance shall have effect notwithstanding any thing contained in the Companies Act, 1913 (VII of 1913), or any other law for the time being in force.

43. **Removal of difficulties**- if any difficulty arises in giving effect to any provision of this Ordinance, the Federal Government may make such order notinconsistent with the provision of this Ordinance, as may appear to it to be necessary for the purpose of removing the difficulty.

President
Islamic Republic of Pakistan

PCPPI – 866 C.L.A – 2.3.88-300

APPENDIX. 2

SAMPLE PROSPECTUS OF A MODARABA COMPANY

(This sample has been re-produced only to promote understanding of the listing procedures and requirements for the *Modaraba* Companies in Pakistan. To avoid presentation of information which was not related to this objective, some paragraphs have been omitted).

FIRST DADABHOY *MODARABA*
Managed by
DADABHOY Modaraba Management (Private) Limited
Incorporated in Pakistan, under
Companies Ordinance 1984 and Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980.
Underwritten by
ICP, DADABHOY Investment Ltd. Bank of Khybar,
Asset Investment Bank Ltd. and
PAK Resources Insurance Company Ltd.

11 AUTHORIZATION FOR THE ISSUE

Authorization has been granted under the Modaraba Companies and Modarabas (Floatation and Control) Ordinance, 1980 for floatation of the provision of section 9 of the Modaraba Companies and Modarabas (Floatation and Control) Ordinance, 1980 has certified that the business proposed to be undertaken by the Modaraba is not opposed to the injunctions of Islam.

1.2 CONSENT OF THE FEDERAL GOVERNMENT

Consent of the Federal Government has been obtained to the issue of capital under the Capital Issues (continuance of Control) Act, 1947 by an order of which a complete copy is open to public inspection at the registered office of DADABHOY Modaraba Management (Private) Limited. It must be distinctly understood that in giving this consent the Federal Government does not take any responsibility for the financial soundness of any scheme or for the correctness of any of the statements made or opinions expressed with regard to them. This also applies to the authorization granted by the Registrar *Modaraba* under section 11 of the *Modaraba* Companies and *Modarabas* (Floatation and Control) Ordinance, 1980.

1.3 APPROVAL OF STOCK EXCHANGE

The Prospectus of the *Modaraba* has been approved by the Karachi Stock Exchange (Guarantee) Limited in accordance with the requirements under their ten days of the closure of subscription list as to what applications have been accepted or are successful and refund the money in case of the unaccepted or unsuccessful applications within ten days of the date of such decision.

1.4 FILING OF PROSPECTUS

A copy of the Prospectus of FIRST DADABHOY MODARABA has been duly filed with the Register Modaraba Companies and Modaraba. Islamabad, as required by Rule 20(2) of the Modaraba Companies and Modaraba Islamabad, as required by Rule 20(2) of the Modaraba Companies and Modaraba Rules, 1981.

1.5 LISTING OF STOCK EXCHANGES

Applications have been made to the Karachi Stock Exchange (Guarantee) Limited, for permission to deal in and for quotation of the First DADABHOY Modaraba Certificates. In accordance with the " Regulations for Trading in Provisionally Listed Companies" , of Karachi Stock Exchange (Guarantee) Limited, the Modaraba shall stand listed provisionally for trading and for quotations of its certificates on that exchange from the next day of balloting. If for any reason the application for official listing is not accepted by the Karachi Stock Exchange (Guarantee) Limited the Modaraba Company undertakes to publish immediately in the press a notice to that effect and thereafter refund without surcharge all the money received from applicants in pursuance.

1.6 REFUND OF MONEY TO UNSUCCESSFUL APPLICANTS

The *Modaraba* Company shall take a decision within ten days of the closure of subscription list as to what applications have been accepted or are successful and refund the money in case of the unaccepted or unsuccessful applications within ten days of the date of such decision.

1.7 OPENING AND CLOSING OF SUBSCRIPTION LIST THE SUBSCRIPTION LIST WILL INSHA ALLAH OPEN AT THE COMMENCEMENT OF BANKING HOURS ON SUNDAY, JULY 31, 1994 AND WILL CLOSE ON THE SAME DAY AT THE CLOSE OF BANKING HOURS

1.8 MINIMUM APPLICATION

Application must be for a minimum of 500 certificates or multiples thereof

Listing Regulations. While clearing the Prospectus the Stock Exchanges do not guarantee the correctness of the contents of the Prospectus nor the viability of the *Modaraba.*

PART II

MODARABA FUND AND RELATED MATTERS

2.1 *MODARABA* FUND AND PRESENT ISSUE

	Rupees	Rupees
Authorized *Modaraba* Fund 10,000,000 certificates of Rs. 10 each fully paid in cash		100,000,000
Subscribed and paid up *Modaraba* Fund		
1,000,000 certificates of Rs.10 each fully paid in cash by DADABHOY *Modaraba* Management (Private) Ltd.		10,000,000

Sponsors	
500,000 certificates of Rs. 10 each fully paid in cash by :	
Associating undertakings	*2,500,000*
Financial Institution - ICP	2,500,000
	15,000,000
Present Issue	
Now offered at par for subscription in cash in full on application to:	
General Public	
Resident Pakistanis	
2,362,500 certificates of Rs.10 each	23,625,000
Non-Resident Pakistanis	
787,500 certificates of Rs.10 each	7,875,000
National Investment Trust Limited	
350,000 certificates of Rs. 10 each	3,500,000
	35,000,000
Paid-up fund of the *Modaraba* after the present issue	50,000,000

The difference of Rs.50,000,000 between the authorized capital and paid-up capital will provide the *Modaraba* with an opportunity to increase the paid-up capital to meet future business requirements.

2.2 *MODARABA* CERTIFICATES ALLOTMENT POLICY

The basis of allotment of the *Modaraba* Certificates offered to General Public shall be as follows "

i. If the *Modaraba* Certificates to be issued to the general public are . sufficient for the purpose, all applications shall be accommodated initially for a minimum allotment of certificates of the face value of Rs.5000, If the certificates applied for by applicants are in excess of the certificates offered to them, the distribution shall be made by computer balloting in the presence of representatives of the Karachi Stock Exchange (Guarantee) limited.

ii. Any certificate left unsubscribed after allotment as aforesaid, shall be allotted on a prorata basis to applicants who apply for certificates exceeding the face value of Rs. 5,000.

in. If the *Modaraba* Certificates to be issued to the non-resident Pakistanis are sufficient for the purpose, all applications from the non-resident Pakistanis shall be accommodated initially for a minimum issuance of Rs.5,000. If the Certificates applied for by such applicants are in excess of the *nominal* value of the Certificates offered to them, the distribution shall be made by computer balloting.

iv. *Modaraba* Certificates left unsubscribed after issuance being made in the manner given under (iii) above, shall be issued, on a prorata basis, to the non-resident Pakistanis, who applied for certificates exceeding the face value of Rs.5,000.

v. Any Certificates left unsubscribed by non-resident Pakistan, after issuance in the manner given under (iii) and (iv) above, together with the quota reserved for the residents minus the amount of certificates subscribed by the National Investment Trust Limited shall be issued to the resident Pakistanis on the same basis as given under (iii) and (iv) above and vice versa for non-resident Pakistanis.

vi. Any part of the *Modaraba* Certificates offered to the National Investment Trust Limited and not subscribed by them shall be offered to the general public at par.

2.3 FACILITIES AVAILABLE TO NON-RESIDENT PAKISTANIS

i. On sale and transfer of the certificates repatriation of sale proceeds with the capital gains, if any, will be allowed provided that certificates are held for not less than one year.

ii. Allottees shall have the option either to receive the dividend income in Pakistani currency or in US dollars, to be specified by them in the application forms.

iii. Disinvestment proceeds and dividend will accrue in Pakistani currency and repatriation thereof will be allowed in accordance with the rules and the exchange rate prevailing on the date of remittance. This facility will be available only if the stay of the investor in Pakistan does not exceed six months.

iv. It will be permissible for non-resident certificate holders to transfer their certificates to other Pakistani nationals ordinarily resident outside Pakistan.

2.4 ISSUE OF *MODARABA* CERTIFICATES

Modaraba Certificates shall be issued within 30 days to the allottees, as required under the *Modaraba* Ordinance through the bankers to the issue.

2.5 TRANSFER OF CERTIFICATES

In terms of the Companies Ordinance, 1984 and Rule 22 of the *Modaraba* Rules, 1981, there are no restrictions on the free transferability of *Modaraba* Certificates where a proper instrument of transfer, duly stamped and executed by the transferor and the transferee has been delivered to the share department of the *Modaraba* Company along with the relevant *Modaraba* Certificates. However, transfer into the names of foreign national will require prior permission of State Bank of Pakistan.

2.6 TRADING OF *MODARABA* CERTIFICATES ON STOCK EXCHANGE

The *Modaraba* Certificates will be transacted on the Karachi Stock Exchanges and will be transferred without any restriction provided they are supported by an instrument of transfer.

2.7 PREFERENTIAL RIGHTS TO SUBSCRIBE

It is a condition of the Consent Order of the Controller of Capital Issues that preferential rights be granted to the National Investment Trust Limited to subscribe for 350,000 certificates against full payment in cash at Rs.10 per certificate. This right may be exercised during the period the subscription list is open for purpose of the present public offer of *Modaraba* Certificates. No consideration has been given or promised to the *Modaraba* Management Company for the grant of these preferential rights.

2.8 MINIMUM SUBSCRIPTION

In the opinion of the directors of the *Modaraba* Company, the amount which must be raised as a minimum subscription in order to provide for the business operation and expenses is the whole amount of the *Modaraba's* present issue of Rs. 50.0 million of which Rs.15 million has already been subscribed in cash by the *Modaraba* Company, associated undertakings and financial institutions.

2.9 INTEREST OF CERTIFICATE HOLDERS

The authorized *Modaraba* Fund is Rs.100,000,000 divided into 10,000,000 certificates of Rs.10 out of which 1,500,000 certificates of the aggregate face value of Rs.15,000,000 have been issued against cash fully paid-up certificates. None of the holders of the issued certificates of the Fund have any special or other interest in the property or profits of the Fund have any special or other interest in the property or profits of the Fund other than as holders of the certificate in the capital of the Funds, except Investment Corporation of Pakistan who are also the underwriters, therefore, they are interested to the extent of underwriting fee that may accrue to them as a result thereof.

2.10 FUTURE CAPITALIZATION

The *Modaraba* Company may make right or bonus issue of certificates as it deems necessary for its business operations after obtaining necessary permission from Registrar *Modaraba*. Furthermore, the right issue shall be made after obtaining necessary permission from the Controller of Capital Issues, whereas bonus issues shall be made by following the provisions of the Capital Issues (Exemption) Order, 1967.

2.11 MODE OF DISTRIBUTION OF PROFITS

Not less than 90% of the net income in respect of the *Modaraba's* business activities, after charging the management fee up to 10% and after setting aside the mandatory reserve as per the State Bank of Pakistan prudential regulations is proposed to be distributed at least once every year to the certificate holders in proportion to the number of certificates held by them. Distribution will be in the form of cash dividend and or bonus certificates.

All the business operations including investments and raising of funds shall be carried out in accordance with the agreements and arrangements already approved or after obtaining approval of the Religious Board.

2.12 TAX EXEMPTIONS

According to the prevailing tax law, *if Modaraba* distributes 90% *of* its profits among the certificate holders after deducting mandatory reserve provisions as per State Bank of Pakistan's prudential regulations, the income of the *Modaraba* is exempt from tax for three years and subsequently will be subjected to a tax @12.5% in the fourth and fifth year and thereafter it will be subjected to tax @25%.

2.13 APPLICATION OF *ZAKAT* AND *USHR* ORDINANCE, 1980

Income distributed shall be subject to deduction of *Zakat* at source according to Zakat and *Ushr* Ordinance, 1980 (XVIII of 1980).

2.14 WITHHOLDING TAX ON DIVIDENDS

Profit distribution to certificate holders shall be subject to withholding tax @10% under section 50(6A) of the Income Tax Ordinance, 1979 and interim of the provisions of section 80-D of the said ordinance such as deduction at source shall be deemed to be full and final liability in respect of such profit. Profit distribution to companies shall be taxable at inter-corporate tax rate for dividends specified in para-D of pars V of the first schedule of the said ordinance.

PART III

UNDERWRITING, FEES, BROKERAGE AND PRELIMINARY EXPENSES

3.1 UNDERWRITING

The present issue of 3,500,000 *Modaraba* Certificates of Rs.10 each have been underwritten by:

		Rupees (Million)
a)	Investment Corporation of Pakistan	7,500
b)	DADABHOY Investment (Private) Ltd.	5,000
c)	Bank of Khyber	5,000
d)	Asset Investment Bank Ltd.	7,500
e)	Pak Resources Insurance Company Ltd.	10,000
		35,000

If and to the extent that the certificates hereby offered to the general public shall not have been subscribed and paid for in cash in full by the closing date, the underwriters shall within 15 days of being dully called upon by the company to do so, subscribe or procure subscribers to subscribe and pay in cash in full, for such unsubscribed certificates.

In the opinion of the directors, the resources of the underwriters are sufficient to discharge their underwriting commitment.

THE UNDERWRITERS HAVE NOT ENTERED INTO ANY BUY BACK AGREEMENT WITH THE SPONSORS OR ANY OTHER PERSON.

3.2. UNDERWRITING FEES

The underwriters shall be paid actual expenses incurred by them for undertaking the obligation of underwriting and the fee on the amount underwritten in accordance with the underwriting agreement entered with them. But no fee shall be payable to the underwriters for mere underwriting the value of certificate/or the certificates actually taken up by them. Provided that the actual expenses and the fee payable shall not exceed *5%* of the amount underwritten by them.

No underwriting fee shall be payable to the underwriters in respect of the certificates taken up by the National Investment Trust Limited by virtue of exercise of its option.

3.3 BROKERAGE

Brokerage shall be paid to the member of Karachi Stock Exchange (Guarantee) Limited at the rate of 1% of the value of *Modaraba* Certificates actually sold through them. No brokerage shall be payable in respect of certificates taken up by the underwriters and the National Investment Trust Limited through exercise of its option for present issue offered to them.

3.5 PRELIMINARY EXPENSES AND EXPENSES TO THE ISSUE

The estimated expenses of the present issue are as under:

		Rupees
i)	Underwriting fees	*427,500*
ii)	Brokerage to members of the Stock Exchange	315,000
iii)	Fees to bankers to the issue	157,500
iv)	Other organizational and floatation expenses inclusive of cost of printing, publishing and distribution of the prospectus, constancy fees and listing fee etc.	*325000*
		1,225,000

These expenses are equal to *3.5%* of the public issue and are payable by the *Modaraba* and shall be written off over five years.

THE *MODARABA* MANAGEMENT COMPANY

4.1 INTRODUCTION TO THE MANAGERS OF THE FIRST DADABHOY *MODARABA*

DADABHOY *Modaraba* Management (Pvt) Limited was incorporated in the Province of Sindh on December 19, 1991 under the Companies Ordinance, 1984. It was registered as *a Modaraba* Management Company with the Registrar *Modaraba* Companies & *Modarabas,* Islamabad on December 14, 1992.

4.2 **CAPITAL**

The Authorized Capital of the DADABHOY *Modaraba* Management (Pvt) Limited is Rs.30,000,000 divided into 3,000,000 certificates of Rs.10/- each with a paid up capital of Rs.12,500,000.

4.3 **PROMOTERS AND MANAGERS OF *MODARABA***

(Names deleted).

PART V

OBJECTS, BUSINESS AND PROSPECTS

5.1 **TYPE** OF ***MODARABA***

First DADABHOY *Modaraba is* a perpetual and for specific purpose trading *Modaraba* as described in the object clause hereunder.

5.2 **OBJECT OF THE *MODARABA***

The object of the *Modaraba is* specifically to carry on domestic and international trading activities as a trading house in the normal and prevalent mercantile practice which are not violative of the injunctions of Islam.

The *Modaraba* will specifically trade in the following commodities and products.

a) Textile Products and Fiber
b) Jute and Jute Products
c) Chemical and Petrochemical Products
d) Agricultural and Food Products
e) Construction Materials and Capital Goods
f) Leather and Leather Products
g) Automobiles & Related Products
h) Any other product, the trade of which is not prohibited by the injunctions of Shari 'ah, after obtaining prior approval of the Registrar, *Modaraba.* The trading of above commodities may include brokerage and advisory services.

5.2-A The *Modaraba* with a view to beneficially carrying out trading in the commodities and products given in Clause 5.2 may make investment for the purchase/acquisition of assets relatable to object clause for manufacture of and/or distribution and storage of the said commodities and products.

5.2-B The fund not exceeding 20% of paid-up fund of the *Modaraba may* be invested for a period of not more than one year in the following:

a) Investment in shares, equity of companies carrying business not prohibited by *Shari 'ah* and non-interest bearing securities and certificates, and;
b) *Musharaka* and *Modaraba* Modes of Islamic Economics in accordance with the instruments approved from time to time by the Religious Board.

5.3 CONCEPT OF TRADING TRANSACTIONS

The *Modaraba* shall abide by the following trading concepts:

a) Modaraba shall not enter into any transaction or business dealing which is violative of the injunctions of Islam and shall not enter into any sale or purchase transaction which is violative of the injunctions of Islam and in all its dealings and transactions shall observe the principles of *Shari'ah.*

Without prejudice to the generality of sub-clause (I) , the *Modaraba* shall adhere to the following guidelines:

b) *Modaraba* shall only transact sale of the products and commodities which it owns as principal or when acting as agent, the product/commodity is owned by its principal.

c) The products/commodities sold or purchased should be in the physical or constructive possession of the seller who shall also bear the risk corresponding to the possession.

d) The sale price on credit will be disclosed before an offer of sale.

e) The contract of sale shall not be contingent.

f) The delivery of goods or the payment of price shall not be contingent on an event which may or may not occur in future.

5.4 MODE OF TRADING TRANSACTIONS

a) The *Modaraba* shall sell its products and commodities on cash and credit basis.

b) Documentation for cash sale will comprise of a simple invoice recording the sale transactions and a cash receipt to signify the receipt of payment.

c) Documentation for credit sale will be through a credit sale contract as approved by the Religious Board.

5.5 RESOURCE MOBILIZATION

It is planned to mobilize additional resources without the element of Riba using following modes:

a) Musharaka
b) Morabaha
c) Modaraba

5.6 **SAFEGUARDS**

a) The Directors of the *Modaraba* Management Company shall exercise strict vigilance over the business of the *Modaraba.* All decisions shall be made on sound business principles, based on the best available advice.

Suitably qualified and experience key personnel will be engaged by the *Modaraba* Management Company for the *Modaraba.*

c) Business and investment decisions shall also be based upon analysis of published accounts, comparable studies and scope of future prospects in the light of expansion programs and market trends.

Separate bank accounts will be maintained by the *Modaraba* Management Company in respect of the *Modaraba.* The account will be operated jointly by two authorized officers/Directors of the *Modaraba* Management Company.

e) Collection account for subscription towards the *Modaraba* Certificates will be operated jointly by two Authorized Officers/Directors of the *Modaraba.* Company.

f) Business transactions shall be conducted in accordance with the applicable laws and regulations in Pakistan and no transactions will be entered into which are in any manner in conflict with injunctions of Islam.

g) The *Modaraba* shall not enter into any business transaction with any person, except in connection with the normal business of the *Modaraba.*

h) The *Modaraba* shall not enter into any business or other transaction which is repugnant to the injunction of Islam or which involves the element of "Riba".

i) The Share Certificates acquired out of the *Modaraba* Fund will be registered in the name of the *Modaraba* in the respective books of the companies issuing the shares.

j) The element of interest shall not be involved, directly or indirectly, in the business of the *Modaraba.*

k) All the *Modaraba* activities and transactions shall be in conformity with the rules and regulations issued by the Registrar of *Modaraba,* State Bank of Pakistan and/or any other competent authority from time to time.

1) In order to ensure adherence with *Shari 'ah* in all its dealings, the *Modaraba* shall utilize the services of a *Shari 'ah* Consultant as and when required, well versed in *Shari 'ah,* particularly relating to business and financial matters, through the *Modaraba* association.

5.7 SPECIFIC SAFEGUARD PRESCRIBED BY THE STATE BANK OF PAKISTAN

a) The *Modaraba* shall maintain both for funded and non-funded financing in each case for the first two years of operation a ratio of equity to liabilities of not less than 1:7 and thereafter the ratio may be increased for each to 1:10.

b) Not less than 20% of after tax profits *of* the *Modaraba* shall be credited to a reserve fund till such time the reserve fund equals the amount of Paid-up Fund of the *Modaraba.* Thereafter sum of not less 5% of the after tax profit of the *Modaraba* shall be credited to the reserve fund. Stock dividend shall be treated as an appropriation for this purpose.

c) Not less than 15% of the *Modaraba* Liabilities excluding Paid-up Fund, borrowings from financial institutions and lease key money shall be invested in NIT Units or any other investments permitted by the Religious Board.

d) Accounts will be obtained regularly from borrowers in accordance with the rules prescribed for non-banking financial institutions by the State Bank of Pakistan.

e) While granting credit facilities, *Modaraba* shall ensure that the total long-term debt to equity ratio of the borrower does not exceed 60:40 as a rule and non-current liabilities of the borrower do not exceed its current assets.

f) Total exposure of the *Modaraba* to a single borrower shall not exceed 20% of its equity. In case of listed companies exposure should not exceed 20% of the *Modaraba's* total assets.

g) Minimum margins shall be obtained against facilities granted to borrowers in accordance with the percentages prescribed by the State Bank of Pakistan.

h) *Modaraba* shall not provide any facility to their directors, Chief Executive and major shareholders including their spouses, parents and children or to firms and companies in which they are interested, as partners, directors or major shareholders. Major shareholder means any person holding more than 5% of the Paid-up Fund or Share Capital.

i) No facilities will be allowed for speculative purposes.

j) *Modaraba* shall not hold, deal or trade in real estate except that in use of the *Modaraba.*

k) Provisions against non-performing facilities shall be made in accordance with the guidelines prescribed by the State Bank of Pakistan.

The *Modaraba* shall have an internal audit department. The head of the department shall report directly to the Chief Executive Officer.

The above safeguards should be read in conjunction with NBFI's Circular No. 1 dated December 5, 1991 issued by the State Bank of Pakistan.

5.8 **BUSINESS PROSPECTS**

It is the declared policy of the government to give priority and encouragement to the private sector in the promotion and development of the economy. the Government has been taking necessary steps and measures from time to time. The current exchange and financial reforms are the part of Government steps to achieve the foregoing objectives. The current financial policy of increase debt to equity ration, non-availability of bridge finance, credit selling, the privatization and deregulation program offer exceptional business opportunity in the money and the capital market as well as the project financing operation. There is scope for finance and advisory services to over, operational (Pvt.) Limited companies to take advantage of growth potential by public participation.

5.9 RISK FACTORS

The *Modaraba* will carry on the trading activities and therefore the management wishes 10 point out the following risk elements involved in the trading activity. These factors relate to :

a) Market situation prevailing in the country and more particularly in the area of activity.
b) General economic conditions.
c) Government taxation, fiscal and industrial policies.
d) Local and international market competition.

The managers of the *Modaraba* will, however, make their best efforts in order to lessen the effects of the above factors on the business of the *Modaraba.*

5.10 **VIABILITY**

Experience and expertise of the DADABHOY *Modaraba* Management (Private) Limited in the field of industry, commerce and trade will be at the back of the all the activities and operations of the *Modaraba.* The promoter's multifarious activities cover a wide range of items of trade and commerce. The promoters of DADABHOY *Modaraba* Management (Private) Limited are, therefore, confident that the First DADABHOY *Modaraba* being floated by them will meet with great success.

5.11 COMMENCEMENT OF BUSINESS OF THE *MODARABA*

Full-fledged business of the *Modaraba*, will be started INSA ALLAH after the present issue and completion of necessary formalities.

5.12 CONDITIONS IMPOSED BY THE CONTROLLER OF CAPITAL ISSUES

a) The Management Company and FIRST DADABHOY *MODARABA* shall neither undertake the business of real estate nor provide funds to the construction companies, builders developers etc., and companies dealing in real estate.
b) the *Modaraba* shall comply with all the conditions of the *Modaraba* authorization certificate of Registrar *Modaraba.*

c) Out of 20 % contribution by the management company, 10% contribution by the management company would become salable after two years with the approval of Registrar *Modaraba.*

d) Friends, relatives, associates, etc. receiving preferential shares form sponsors' quota would not sell their certificates for period of two years.

PART VI

FINANCIAL INFORMATION

6.1 AUDITORS' CERTIFICATE UNDER THE *MODARABA* COMPANIES AND *MODARABA* RULES, 1981

We certify that the First DADABHOY *Modaraba:-*

a) has received subscription from :

		Rupees
i)	DADABHOY *Modaraba* Management (Private) Limited	
ii)	Sponsor, Associated undertaking Financial Institution	10,000,000

		15,000,000

b) has not done any business or acquired any property.

Sd/-
(Name deleted).
CHARTERED ACCOUNTANTS
Karachi:
Dated: May 28, 1994.

6.2 FINANCIAL YEAR

The financial year of the First DADABHOY *Modaraba will* be from January 01 to December 31 each year.

PART VII

7. DIRECTORS OF THE *MODARABA* MANAGEMENT COMPANY

7.1 INFORMATION IN RESPECT OF GROUP COMPANIES

(Names deleted).

Sr.	Name of Company	1993	1992	1991	1990	1989
1.	Pak Resources Insurance Co.Ltd.	Nil	15% R-1.1	10%	Nil	Nil
2.	C&K Management Association	Nil	Nil	Nil	Nil	
3.	Crescent Leasing Corporation Ltd.	Nil	Nil	Nil	Nil	Nil

7.2 **OVERDUE LOANS**

There have been no overdue loans in respect of the above companies during the last five years.

7.3 **CHIEF EXECUTIVE**

(Names deleted).

7.5 **ADMINISTRATION - MANAGEMENT OF FIRST DADABHOY *MODARABA***

a) The *Modaraba* Company shall also maintain register of *Modaraba* Certificate holders and only certificate holders in the said register shall be deemed to be owner thereof.

b) The Modaraba Management Company shall keep separate books of accounts relating to the income and expenditure of and connected with the Modaraba or other Modarabas. The books of accounts shall be open to inspection by the directors and auditors of the Modaraba Management Company and the auditors of the Modaraba.

c) The *Modaraba* Company shall, within two months of the first half of the financial year, prepare and submit the financial position of the *Modaraba* whether audited or otherwise, besides any other statements or information that the Board of *Modaraba* Company may like to include, to the Registrar of *Modarabas* and to all registered certificate holders.

d) Within six months of the close of the accounting year of the *Modaraba,* the *Modaraba* Management Company shall prepare and circulate to holders of *Modaraba* Certificates.

   i) The annual balance sheet and profit and loss account;
   ii) A report of the auditors on the balance sheet and profit and loss account;
   iii) A report by the *Modaraba* Company on the activities and business prospects of the *Modaraba* and the profits for distribution to the certificate holders; and
   iv) Any other statement or information that the Board of the *Modaraba* Management Company may like to include.

e) M/s. M. Yousuf Adil & Co., Chartered Accountants have given their consent to act as Auditors of the *Modaraba.* The Registrar, *Modaraba* Companies and *Modarabas,* Islamabad has approved the appointment of M. Yousuf Adil & Co., Chartered Accountants as auditors of the First DADABHOY *Modaraba* for the first accounting year. This fees will be Rs. 25,000/- per annum. The *Modaraba* auditors will be appointed and approved on an annual basis as required under *Modaraba* Ordinance and Rules.

f) The accounting record of FIRST DADABHOY *MODARABA* will be kept on the basis of financial year ending on the last day of December each year.

g) The *Modaraba* Company will provide office space, custodial and management service and charge a management fee at the rate of 10% per annum of the net annual profits of the *Modaraba.*

h) The *Modaraba* Company shall be competent to do all other acts which in its opinion may be necessary to promote the interest of the certificate holders based on investment climate in Pakistan and else where and the condition of the capital market and as may be warranted by commercial consideration.

7.6 INTEREST OF THE *MODARABA* COMPANY, AND ITS DIRECTORS AND OFFICERS

Modaraba Management Company is interested to the extent of its capital investment in the *Modaraba* and also in management fee to the extent of 10% of the annual profit of the *Modaraba.* There is no other interest of *Modaraba* company and its directors and officers in promoting the *Modaraba* or proposed to be acquired by the *Modaraba.* The Directors deemed to be interested in the dividends payable on the *Modaraba* that may be acquired by them. .

PART VIII

MISCELLANEOUS

8.1 NAME OF *MODARABA*	**Dadabhoy *Modaraba***
8.2 PRINCIPAL PLACE OF BUSINESS/SHARE DEPT.	**Ebrahim Estate D-1A, Block 7&8 KCHSU Sharea Faisal, Karachi Tel: 440012-4 Fax: 4547301**
8.3 NAME OF MANAGEMENT COMPANY AND ITS REGISTERED OFFICE	**Dadabhoy *Modaraba* Management (Pvt.) Ltd. Ebrahim Estates D-1A, Block 7&8 KCHSU Sharea Faisal Karachi Tel: 440012-4 Fax : 4547301**

8.4 **BANKERS TO THE *MODARABA***	Allied Bank of Pakistan National Development Bank Finance Corporation Limited
8.5 BANKERS TO THE ISSUE (LOCAL)	01 Allied Bank of Pakistan Ltd. 01 Allied Bank of Pakistan Ltd. 02 First Women Bank Limited 03 Habib Bank Limited 04 Habib Bank AG Zurich 05 Mehran Bank Limited 06 Muslim Commercial Bank Ltd. 07 National Bank of Pakistan 08 United Bank Limited
8.6 BANKERS TO THE ISSUE (OVERSEAS)	01 Habib Bank AG Zurich 02 Habib Bank Limited 03 United Bank Limited
8.7 AUDITORS OF THE *MODARABA* MANAGEMENT COMPANY	M/s Mehmood Zuberi & Co. Chartered Accountant & Co. Al-Amna Plaza M.A. Jinnah Road, Karachi
8.8 AUDITORS OF THE *MODARABA*	M/s M. Yousuf Adil & Co. Chartered Accountants A-35, Block 7&8 Cavish Court, K.C.H.S.U. Sharea Faisal, Karachi Phone: 446056-9 Fax: 442841
8.9 LEGAL ADVISORS	Syed Raizul Hassan Advocate 9, Yousuf Chamber M.A. Jinnah Road, Karachi

8.10 CONSULTANTS TO THE ISSUE	Mts. M. Yousuf Adil & Co. Chartered Accountants, Cavish Court, A-45, Block 7&8, KCHSU Sharea Faisal, Karachi Phones: 446056-9 Fax: 442841
8.11 COMPUTER BALLOTINGM.	Yousuf Adil & Associates (Pvt) Limited A-37, Block 7&8 Susaka Chamber KCHSU, Sharea Faisal Karachi Phones: 446056-9 Fax : 442841

8.12 MATERIAL CONTRACTS

a) Equity Participation agreement dated May 11, 1994 has been entered with Investment Corporation of Pakistan for Rs.2.50 million.

b) Underwriting agreement dated May 11, 1994 with Investment Corporation of Pakistan for underwriting of the present issue of Rs.7.50 million.

c) Underwriting agreement dated March 24, 1994 with DADABHOY Investment (Private) Limited for underwriting of the present issue of Rs.5.00 million.

d) Underwriting agreement dated April 27, 1994 with Bank of Khyber for underwriting of the present issue of Rs.5.00 million.

Underwriting agreement dated April 18, 1994 with Asset Investment Bank Limited for underwriting for the present issue of Rs.7.50 million.

f) Underwriting agreement dated March 24, 1994 with Pak Resources Insurance Company Limited for underwriting of the present issue of Rs. 10.00 million.

8.13 INSPECTION OF DOCUMENTS AND CONTRACTS

Copies of Memorandum and Articles of Association of the management company, the consent order of the Controller of Capital Issues, the Auditors Certificate and copies of the agreements and Feasibility Report to in this prospectus may be inspected during the usual business hours on any working day at the Registered Office of the management company from the date of publication of this prospectus till the closing of the subscription list.

8.14 LEGAL PROCEEDINGS

There are no legal proceedings against the Management nor has the Management Company initiated any legal proceedings against any party.

8.15 CERTIFICATE OF RELIGIOUS BOARD

The Religious Board constituted under Section *9* of the *Modaraba* Companies and *Modaraba* (Floatation and Control)· Ordinance, 1980 has approved the' proposal of DADABHOY *Modaraba* Management (Private) Limited for floatation of the First DADABHOY *Modaraba* and has certified that the floatation of the First DADABHOY *Modaraba* as per Prospectus submitted by DADABHOY *Modaraba* Management (Private) Limited is not opposed to the injunctions of Islam.

8.16 FULFILLMENT OF THE REQUIREMENT OF VARIOUS CLAUSES OF FOURTH SCHEDULE OF *MODARABA* COMPANIES AND *MODARABA* RULES, 1981

As required under clause 19, 20 and 26 of the schedule, it is clarified that no property has so far been purchased or acquired or is proposed to be purchased or acquired and· that no business has also so far been carried on by the *Modaraba.* It is also confirmed that no amount has been paid or benefit given to the *Modaraba* Company. As required under clause 21 of the Fourth Schedule under reference, no amount is paid within the two preceding years or payable as commission for subscribing or agreeing to subscribe or procure or agreeing to procure subscription for any certificates of the *Modaraba,* except as disclosed in this prospectus.

PART IX

9.1 THE FORM OF *MODARABA* CERTIFICATE

FIRST DADABHOY *MODARABA*
Managed by
DADABHOY *MODARABA* MANAGEMENT
(PRIVATE) LIMITED

Authorized Fund Capital Rs. 100,000,000/-

DIVIDED INTO 10,000,000 CERTIFICATES OF RS. 10/- EACH

This is to certify that is/are the registered holder(s) of 100 fully paid *Modaraba* Certificates of Rs. 10/- each numbered as below in FIRST DADABHOY *MODARABA* subject to the terms of the Prospectus and that a sum of Rs. 10/- has been fully paid for each Certificate.

Father's/husband's Name:

Address:

Folio No.	Certificate No.	Distinctive Nos.		No. of Certificates
		From	To	

Given under the Common Seal of the Company Director

This day of 199 Director

PART X

APPLICATION AND ALLOTMENT INSTRUCTIONS

1. Name and addresses must' be written in full in block letters in English and should not be abbreviated. All applications must bear the signature and address corresponding with that recorded with the bank in the applicant's account. IN CASE OF DIFFERENCE IN SIGNATURES RECORDED WITH THE BANK AND THOSE ON THE NATIONAL IDENTITY CARD, BOTH SIGNATURES SHOULD BE AFFIXED ON THE FORM.

2. Applications must be made on the *Modaraba's* printed form or photo copy thereof

3. a) Attested copy of National Identify Card should invariably be enclosed and the number indicated on each application except in case of the applications filed by the ICP on behalf of its account holder/ investors. Copy of National Identify Card can be attested by any Federal/ Provincial Government, Gazetted Officer, Councilor, Bank Manager, Oath Commissioner or Head Master of High School etc.

   b) Original Identify Card along with one attested photo copy must be produced for verification by the Branch at the time of presenting an application. The attested photo copy will, after verification, be retained by the branch along with the application.

4. a) Application must not be for less than 500 certificates of Rs.10/-each.

   b) *Modaraba* Certificates will be issued in lots of 100 certificates of Rupees 10/- each.

5. Copies of the Prospectus and Application Form may be obtained from the members of the Karachi Stock Exchange (Guarantee) Limited, the Bankers to the issue and their branches, Consultants to the issue and head office of the DADABHOY *Modaraba* Management (Private) Limited.

6. a) Remittance for the full amount of certificates must accompany each application and must be forwarded to any of the bankers to the issue. Remittance should be in the form of cheque or draft drawn payable to one of the bankers to the issue "A/C FIRST DADABHOY *MODARABA"* and crossed "A/C PAYEE ONLY" and must be drawn on a bank in the same town as the bank to which the application form has been sent. Subscription money must be paid by cheque drawn on applicants' own account.

   b) Only one application will be accepted against each account. In case of joint accounts, one application will be accepted in the name of each of the joint account holder. No application will be accepted in the name of person shown as minor in the records of the bank.

7 Application By Non-Resident Pakistanis

a) Non-Resident Pakistanis are instructed not to mail their application money/foreign currency drafts to Pakistan as these will not be entertained.
b) Non-resident Pakistanis are allowed to deposit the subscription money in cash in any branch of the Bankers to the Issue abroad or remit by draft to any authorized bank in nearest city abroad.
c) A Non-Resident Pakistan national must submit the application in duplicate along with the declaration attached to the application form.
d) PAKISTANIS RESIDING IN SAUDI ARABIA may send their application forms along with bank draft drawn on any Bankers to the Issues in BAHRAIN A/C. "FIRST DADABHOY *MODARABA"* to reach them on or before the close of subscription list.
e) Non-resident Pakistanis must mentioned their Pakistan's address on the application forms.
f) Only one application will be accepted against each account. In case of joint accounts, one application will be accepted in the name of each of the joint account holders. No application will be accepted in the name of person shown as minor in the records of the Bank.

8. Application shall not be made by or on behalf of minors and/or person of unsound mind or firms or trusts. Applications made by Companies and bodies corporate must be accompanied by a copy of their Memorandum and Articles of Association or equivalent instrument. Where applications are made by virtue of power of attorney, the power of attorney must be lodged with the application.

9. Joint application by more than four persons shall not be accepted. In case of joint application each person must sign the application form. The *Modaraba* Certificates will be dispatched to the person whose name appears first on the application form through the bank where the application is tendered, or by post and where any amount is refundable in whole or in part, the same will be refunded by cheque and by post to the person named first on the application form without interest or through the bank where the application is tendered.

10. Bankers are not allowed to make application for the *Modaraba* Certificates of the value of Rupees 5000/- on account of their constituents. Such application shall be made by the subscriber himself complete in all respects and shall be certified by the Bank Manager as provided in the application form *Modaraba* Certificates in respect of such applications shall be issued in the name of the applicant and sent to the postal address stated by the applicant or to the Bank through which the application is tendered. These shall not be issue in the name of the bankers.

11. Application for the *Modaraba* Certificates above the value of Rupees 5000/- may be made by banks on behalf of their constituents but must contain all information in respect of each constituent on the application form. All such applications made by banks must also be certified by the Bank Manager concerned as provided in the application form. *Modaraba* Certificates in respect of such applications will be made in the names of banks on account of the constituent and the relevant *Modaraba* Certificates and advises for refund will be sent to bank concerned.

12. No receipt will be issued for payment made with the application but an acknowledgment will be forwarded in due course either by issue of *Modaraba* Certificate in whole or-in part or by refund of the money paid

with the application. The Bankers to the issue will issue provisional acknowledgment for application lodged with them.

13. It should be permissible for a bank to refund subscription money to an unsuccessful applicant having an amount in that bank crediting such account instead of remitting the same by cheque, pay order or bank draft. Applicants should, therefore, not fail to give their bank account number.

14. Allotment shall be made in accordance with the instructions laid down by the Controller of Capital Issues/Corporate Law Authority.

15. Applications shall be subject to pre-ballot as well as post ballot scrutiny. Applications which do not meet the above requirements or applications which are incomplete will be rejected.

16. In case of applications made by a banker or a Stock Exchange Broker, the banker or the broker shall obtain the certificate from the applicants in term of paragraph (3) of the application form and forward the same in original to DADABHOY *MODARABA* MANAGEMENT (PRIVATE) LIMITED with the application.

17. Making any false statement in-the application or willfully supplying of incorrect information therein will make the applicant or the bank liable to legal action.

18. The *Modaraba* Certificates will be dispatched through the bankers to the issue.

SIGNATORIES TO THE PROSPECTUS

(names deleted)

Karachi.
Dated: 21st July, 1994

Subscription date: During Banking Hours on Sunday July 31, 1994

Tk/r

Legal Deposit no. 3044/16
ISBN: 9960-627-91-8

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 Qa'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 48 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 head office is located in Jeddah in the Kingdom of Saudi Arabia and the Bank is authorized to establish agencies or branch offices 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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