REDEEMABLE ISLAMIC

FINANCIAL INSTRUMENTS

AND CAPIATAL PARTICIPATION

IN ENTERPRISES

ISLAMIC RESEARCH AND TRAINING INSTITUTE (IRTI)

Establishment of IRTI

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 IDB 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* shin 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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REDEEMABLE ISLAMIC FINANCIAL INSTRUMENTS AND CAPITAL PARTICIPATION IN ENTERPRISES

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FOREWORD

Assisting interested institutions in the introduction of an efficient *riba-free* financial system is one of the basic objectives of the Islamic Research and Training Institute (IRTI) of the Islamic Development Bank (IDB). In this regard, IRTI considers that useful lessons can be drawn from the successful operation of Islamic banks during the past 25 years.

Islamic banks have to rely on profit and Loss Sharing (PLS) comprising mainly *of mudharabah* and *musharakah* modes and deferred sale *(bay' murabaha lil amer bi al shira;* mark-up) as the two *parent* principles of financing. The articles of agreements establishing some Islamic banks have given priority to the use of PLS in their operations. Islamic scholars have also been urging the Islamic banks to enhance the flow of participatory capital in their supply of funds. However, a number of practical difficulties have kept the use of the PLS principle limited. The author of this paper argues that development of redeemable PLS instruments may be instrumental in enhancing the flow of PLS funds in Islamic financing.

Apart from the introductory and concluding sections, the paper consists of six sections dealing with various aspects of the subject arguing that a redeemable financial instrument has the capability of providing a comprehensive financing mechanism. The paper also argues that redeemable financial instruments are also expected to promote self-financing, thus ensure growth as well as restrict the enterprises exposure to interest to a minimum level. It is also proposed that under certain conditions, the sale-based finance can be made subordinate to the PLS which can enhance the cash flow of Islamizing enterprises. In the framework of the ongoing efforts to develop Islamic financial instruments, the arguments put forward in this paper may be found useful

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I

INTRODUCTION

1.1 BACKGROUND

Participation in the capital of enterprises offers a crucial investment opportunity for investors who abstain from interest; the enterprises, in turn, mobilize resources. Ideally, capital participation entails providing finance in the form of funds' by acquiring ownership. Examples of participation in the risk of an enterprise are the ownership of capital shares in *musharakah;* the ownership of capital and entrepreneurial qualities in *mudharabah* and the resultant responsibilities for the uncertainty of outcome respectively, in the two cases. *Mudharabah* and *musharakah* are hence, the traditional Islamic modes of finance - that are based on participation, leading to profit and loss sharing (PLS).

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

[1] Durable asset participation is another form of risk sharing *through* allocation of rentable assets instead of funds (for details see, Al Masri I986).

[2] The authors of the report on Islamization of the financial system in Pakistan also treat profit sharing as the foremost alternative for the interest-based financial system. See Council of Islamic Ideology Pakistan (1981).

[3] See particularly, Siddiqi (1987, I993) Ahmad (I985) and Khan (1992).

[4] Why the Islamic banks should enhance the flow of participatory capital in their total supply of funds, or why currently they are not doing so are questions of academic as well as policy interest and are being discussed in several studies, see, e.g., Khan (I994).

[5] In its 7th Session held in Jeddah, 7-121II/1412H (May 9-14, I992), the learned Fiqh Academy formally considered the legal status of Islamic banks' owning shares of such companies' whose capital structure includes interest-based funds and the resolution was made that: "....it is originally unlawful to participate in companies dealing sometimes in unlawful things, like interest etc.; despite the fact that their activities are basically lawful". This resolution was reiterated in the recommendations of the seminar on *Problems of Islamic* Banks, jointly organized by the Academy and IRTI, held in Jeddah during 22-10-I413H (14-4-1993).

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

1.2 EFFORTS IN ISLAMIZING THE CAPITAL STRUCTURE OF ENTERPRISES

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

Capital Re-Structuring

The first group of efforts is related to the exploration of possibilities where existing interest-based debts of specific firms could be replaced by Islamically acceptable alternatives[6]. Once the capital structure is cleaned from interest, investors can participate in the capital of such enterprises. The crucial parameters for the success of these *efforts* are: i) Willingness of the management of enterprises to replace their existing interest-based debts with Islamically acceptable forms of funds, ii) Availability of the Islamic alternatives to achieve the objective and iii) Once the capital is replaced appropriately, its maintenance overtime.

If a typical firm is willing to replace its existing interest-based debts, what are the possible Islamic alternatives?' The problem is simply one of availability of cash, so that the firm can pay its debts. In this regard, the ongoing *efforts* refer to some possible arrangements. The cash-fund may be provided by an Islamic financier by purchasing part of the assets of the indebted enterprise

[6]In this regard, the IDB has initiated a Pilot Project of replacing interest-based capital with Islamic alternatives in some of the companies where the IDB has an equity stake.

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

and either selling these back on installments, leasing them back' or assuming the role of a partner in the enterprise. In addition, flow of the company's retained savings may be diverted towards the payment of the debts. This can be ensured if an Islamic financier provides funds to meet those needs which the company would have otherwise met by its retained profits. The cash flow of the enterprise may be enhanced by raising its equity capital' .

Development Of Financial Instruments

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

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

1.3 OBJECTIVES

Given the above background, the present paper attempts at putting forward some considerations for enhancing capital participation in enterprises

[8] Although this method is suggested in IDB (I994), *sharia'h,* objections are raised against such arrangements.

[9] See IDB (1994).

within the framework of the OIC Fiqh Academy Resolution. The specific objectives of the paper are to discuss the:

1. Limitations imposed on the wider use of the profit sharing principle of Islamic financing by the predominantly non-redeemable notion of the PLS,

2. Need for, and feasibility of redeemable PLS for use in ongoing enterprises, such as sole-proprietorships,

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

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

1.4 SCOPE

The subject matter of the paper is restricted to arguing that redeemability of Islamic PLS finance and attachment of participatory characteristics with the existing sale-based redeemable financing arrangements, will contribute to the enhancement of capital participation in enterprises. This in turn, will promote profit retention, self financing and promotion of Islamic enterprises and Islamic investment opportunities. Only by way of example, some forms of the proposed redeemable PLS and attachment of participatory characteristics with installment purchase are suggested. In other words, this paper does not aim at presenting any detailed scheme of redeemable Islamic financial instruments.

1.5 OVERVIEW

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

II

COMPREHENSIVE FINANCING MECHANISM[10] AND ITS NEED IN AN ISLAMIC ECONOMY

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

2.1 MODES OF FINANCING AND COMPREHENSIVE FINANCING MECHANISM

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

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

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

Although, hiring, installment purchase, and spot sale of owned assets and *mudharabah* etc., serve the purpose of financing but, neither of these can function as a comprehensive financing mechanism. Exhibit-1, highlights this comparison between the implications of a mode of finance and a ;comprehensive financing mechanism for an enterprise. Hiring and installment purchase are not comprehensive, because, these are specific to the equipments/assets in question. For some reasons, if the company needs cash, installment purchase or hiring does not directly meet such requirements. But on the other hand, if cash is available to the enterprise, it can always purchase the required equipment. *Mudharabah* and *musharakah* arrangements directly meet the company's cash requirements. But both of these essentially lead to a change in the ownership structure of the enterprise. Thus, enterprises which need cash, but, for the time being, not wanting or being able to change their ownership structure would find hard to compromise.

The summary of Exhibit-I, is re-produced as Exhibit-2. The choice of most enterprises for a financing mechanism is expected to be effected by three basic inter-related considerations:

i) acquisition of, or access to equipments by the enterprise,

ii) direct adjustment of the enterprise's cash flows" and

iii) separation of the financing decisions from decisions related to the ownership structure or non-interference of the financing mechanism in the ownership structure of the enterprise.

From the brief comparison of Exhibit-2, it can be seen that installment purchase and hiring, simultaneously meet only two namely, acquisition or access to assets and non-interference in the ownership structure, out of the three requirements of the firm. These two modes however, do not meet the requirement of the enterprise for direct cash flow adjustment. The *mudharabah* and *musharakah* mechanism**,** on the other hand meets both the requirements for asset acquisition and direct cash flow adjustment, but aggravates the non-interference requirement. A comprehensive financing mechanism is one which meets all the three requirements simultaneously. An interest-free comprehensive financing mechanism is thus needed by an Islamic economy.

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

From what is discussed above briefly, the following characteristics of a an Islamic comprehensive financing mechanism can be derived:

i) It is a mechanism which by itself is derived from a financing or enterprising principle,

ii) It is always available in the form of cash,

iii) It does not interfere in the organizational structure of the enterprise,

iv) It remains in the ownership of the provider,

v) It is in general capable to replace all other forms of finance in a an ongoing enterprise and

vi) In the longer-run perspective, it does not cause a change in the ownership structure of the enterprise.

<u>Exhibit-1</u> Comprehensive Financing Mechanism and Modes of Financing

Financing Mechanism	Form of Financing received by the enterprise	Effect of Financing on the Enterprise	Implications of the Financing Mechanism for the Ownership Structure of the Enterprise	Possible Response of the Enterprise to Ownership Implications of the Financing Mechanism
Sale-based Modes	in kind	Addition to or re-placement of equipment	Expansion in the asset-base thus liabilities but no change in the ownership structure. Enterprise strengthened by the addition of new assets	If there is a need for the equipment, it will be a welcome addition
Leasing	in kind	Addition to or replacement of equipment	No change in asset-base thus liabilities. No change in ownership structure. But, since the equipment is only temporarily attached to the enterprise, in the longer-run its implications could be	If the purchase of the equipment is not feasible, the enterprise will unwillingly rely on the borrowed equipment

Mudharakah Mudharabah	in kind or cash	a) Addition to or replacement of equipment b) Direct adjustment of cash flow	If the enterprise is a one transaction activity, the expected ownership change is irrelevant, But if the enterprise is an ongoing activity, the ownership structure of the enterprise must change. Addition to asset-base but no change in liabilities as	An excellent option for a one transaction enterprise. But for an ongoing enterprise, where ownership change is inevitable, the decision will depend on the needs of the enterprise and its preference for the change
Comprehensive Financing Mechanism	cash	a) Addition to or replacement of equipment b) Direct adjustment of cash flow	No change in the ownership structure, but addition to the asset-base, no change in liabilities as such*	Best preference if the enterprise is not willing to undergo any type of ownership change, particularly if cash is needed.

' It may be noted that, in the balance sheet of an enterprise each asset must has a corresponding liability, in this sense the liabilities must also change as a result of the change in the asset-base. Nevertheless, these financing mechanisms do not create any fixed liabilities. The relevant connotation is used in this sense.

Exhibit-2 Matching Financing Mechanisms with Important Considerations of Enterprises

Financing Mechanism	Acquisition of or Access to equipments	Direct adjustment of cash flows	Non interference of financing in the ownership structure
Installment purchase/hiring	yes	no	yes
Mudharabah Musharakah	yes	yes	no
Comprehensive financing	yes	yes	yes

2.2 **FORMS OF ENTERPRISES** MODES OF FINANCING

Most Islamic modes of financing have the dual connotation of mode of financing and form of enterprising. In fact, in their original form, the characteristics of *mudharabah, musharakah, muzara'* , *muzara'* and *istisna'* in the sense of enterprises or companies are more dominant than their characteristics as modes of financing. Indeed, *a mudharabah* or *muzharakah* enterprise is established to overcome the difficulties related to both manpower and finance12,13

[12] To illustrate this point, we may refer to the pre-revelation *mudharabah* enterprise between Lady Khadijah and Mohammad (peace be upon him). As the story is narrated, Khadijah was a

As a comprehensive financing mechanism must be in the form of cash, among the Islamic forms of enterprises, only the first four arrangements remain relevant for comparison. The limitations of these business forms in rendering financing functions at a wider scale can be identified with their requirement to establish new enterprises, each time, when more funds are needed.

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

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

In context of the modem enterprise as an ongoing concern, the same logic is applicable to the Islamic forms of business organizations. For instance, when a *mudharabah* or *mudharabah* company is established, the matter of its financing continues. In the most common form of the traditional *mudharabah - a* single transaction enterprise, the differentiation between the two cycles of financing is

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pious rich lady. She needed a *pious* and honest manger for her funds. Mohammad (peace be *upon* him) *was* approached to manage these funds through *a mudharabah* enterprise. The point *is* that the *mudharabah* was initiated as an enterprise for managing surplus funds rather than financing to finance a deficit. But this enterprise, financed the utilization *of* the entrepreneurial talents *of* Mohammad (peace be upon him). It naturally implies that ***mudharabah*** inevitably leads to the establishment *of* an enterprise.

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

not required. But, if a *mudharabah* or *musharakah* enterprise of longer-term duration is visualized as an ongoing concern, e.g., in the form of partnership, joint stock companies, the Unit Investment Fund of IDB or Pakistani *Mudharabah* Companies, etc., the difference between the two cycles becomes evident. Overtime, the *mudharabah* or *musharakah* company will itself need financing. Moreover, as a sole proprietorship and *a mudharabah* are two different forms of enterprises, we should not expect any one of these enterprises to serve as a financing mechanism for the other enterprise.

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

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

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

III

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

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

3.1 INITIATING INFANT ENTERPRISES

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

It is argued that when the enterprise starts functioning, the entrepreneur gets acquaintance with its operation, his risk profile improves, and he is expected to manage more and more risks over time. The proper development of this improving risk profile is in the interest of the financial and economic system. In this regard, the most effective mechanism would be to assign more and more ownership responsibilities of the enterprise to the entrepreneur. The logical

[14]An interested reader may refer to Siddiqi (I983) and Chapra (I986) for how removing the collateral requirement profit sharing can encourage small enterprises on mere efficiency grounds, to Khan (1992) how profit sharing is conducive to human resources development, to Khan and Boulem (I993) how to vitalize the profit sharing principle to vitalize small enterprises and to Mohsin (1994) for institutional arrangements for the promotion of these enterprises.

[15]For a more formal discussion of this point, see Khan (1992).

[16]Islamic economists also argue that the social security system provided by *zakah* will provide a

shield against such risks.

implication of this mechanism is a gradual withdrawal of the financier from the project by redeeming his funds. This will also relieve the financier to support other infant projects" . This reasoning, nevertheless, implies a reverse-order capital structure relationship. As a convention, when an enterprise grows it sells stocks. In the present case, as the enterprise grows, it is expected to become a sole proprietorship. Nevertheless, in context of Muslim countries, for instance, Bangladesh, Indonesia or Pakistan, such a promotional policy can be considered logical and rational.

3.2 CAPITAL STRUCTURE OF SOLE PROPRIETORSHIPS

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

The existence of sole proprietorships at a large scale, in itself is an evidence of the fact that for certain justifications of their own, the owners of these enterprises prefer their typical ownership structure. As sole proprietorships do not like to associate others with their enterprise, they cannot utilize *musharakah or mudharabah* finance. Even if these opt to mobilize funds by. issuing stocks to the public, they cannot do so until their operations reach a minimum size. In addition, the relative cost of issuing stocks is much higher for smaller enterprises compared to bigger firms, effecting their relative competitiveness". The availability of appropriate form of finance (finance which is consistent with their ownership

[17]For more discussion of this point see Khan (I993) and Khan and Boulem (I993) provide a formal model.

[18]According to the Small Business Administration Department of the US Government, 98% of all business in the US is considered as small, these provide about 60% of total US business employment, 100% of new jobs in US industry, these enterprises innovated more than half of all US product and service innovations since the early forties. For more details see Brigham, (I992). [19]The

[19]flotation cost is estimated as 4% for offerings worth more than US $50 million and 21 % for offering up to $ 1 million. Given the same rate of dividend payout the cost of equity for the smaller firm is I9% compared I5.6% for the larger firms. In addition the market rate of return on stocks of smaller firms is also reported to be high - the market also charges more. See ibid.

structure) is an important known factor for the growth of these small enterprises into joint stock companies.

Financing Sole Proprietorships.

The capital structure of these enterprises may contain debt as a natural result of shortage of internal resources to finance either the establishment of the enterprise or its expansion. But, since these are solely owned by a single person, by definition, the capital structure of such firms shall never contain external funds such as *mudharabah, musharakah,* or common stock. In other words, due to their typical ownership structure, these enterprises could not benefit from the traditional Islamic participatory modes of financing or from the equity finance. This should be seen as a universal rather than a localized phenomenon20. Hence, in the absence of an Islamically acceptable comprehensive financing mechanism, these enterprises could face serious financial constraints compared to enterprises which can use interest-based finance. Since comprehensive Islamic finance in not available in the Muslim world, enterprises which use interest-based funds are in a relatively advantageous position compared to those which avoid interest. Once grown as corporations on the basis of interest, it is natural for these corporations to become indifferent to the Islamic injunctions against interest.

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

[20]Although in the framework of the present paper it is irrelevant to ask sole proportorships for *mudharabah* or *musharakah,* some recent emperical studies confirm this proposition. See al Hajjai and Presly, (I992) for the prefernces of these enterprises for mode of financing in a capital surplus country. Also see Babikir (I990) for the preferences of firms in a capital deficit country.

Informal Financing

In the developing countries, sole proprietorships mostly get finance from informal sources. In the traditional Islamic framework, financial accommodation in the form of cash can only be provided either as *qard* (interest-free loan) or by participating in the risk profile of the enterprise through *mudharabah* or *mudharabah"* .

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

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

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

3.3 CAPITAL STRUCTURE OF JOINT-STOCK COMPANIES

The discussion of this sub-section inevitably leads us to the controversy between different theories of capital structure of the firm. The competing theories try to explain several related phenomenon: Why some firms rely more on internal financing compared to others? Why firms combine debt and equity? Why firms issue common and preferred stocks? Why firms sometimes buy their own stock? What is the optimal policy related to these issues? Why this optimal policy is different for different firms and even for the same firm in different times? These numerous and complex issues are thoroughly analyzed in the relevant literature. It is not the objective of this paper to deal with these complex issues[22].

In this context, *in a broader sense,* it is relevant to mention that, after decades of domination by the neo-classical and Keynesian theories (led by the Miller-Modigliani propositions), the traditional capital structure theory has re-emerged. In simple terms, the intuitively appealing implication of this several decades old theory is that, *the first preference of firms is to finance their growth from internal sources. If firms have to choose between debt and equity, they will prefer debt simply because it is consistent with their first preference.* The preference for internal financing, is in fact, a preference for internal ownership. The stronger is the internal ownership, the more it is secure to borrow, i.e., borrowing is consistent with internal financing. On the other hand, the strength of internal ownership in fact, weakens external ownership and vice-versa" .

The re-emphasis on this theoretical premises has been strengthened by at least two considerations. First, tax, bankruptcy, and agency costs (moral hazard, adverse selection etc.), all relate to external (stocks) rather than internal financing. Second, profit retention (which is a positive function of the size of internal ownership and an inverse function of external ownership) improves cash flows and capital base of the firm, hence enhances its growth prospects. Recent studies reveal that for the I970-85 period, in average, corporations in the G - 7 countries met 73% of their financing needs by their retained earnings, 22% through longer term bank-industry relationships as direct equity linkages or loans and the

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

[23] See, e.g., Myers (I984), Myers and Majluf (I984). The robust signalling theory advices that investors should suspect the intention of large corporations whenever these issue new stocks. Because, if the prospects of the corporation were good, why should corporations share it with stock holders? Conversely, they will only try to share the bad prospects of the enterprise. In other words, if the prospects are good they will borrow and if bad issue stocks!.

remaining 3% through stock markets'. The average figures for direct bank-industry relationships are in fact inflated by the high dependence of West German and the Japanese Corporations on this source of funds.

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

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

Stock markets have also contributed to the elimination of risk-aversion by enhancing portfolios of assets whose returns are negatively correlated. As a result, under the normal functioning of the market, even with a decline in the price of a stock, for instance, from $30 to $I0 next morning, investors still stand gainers because the price of the other assets held in the portfolio must increase.

Thus the gambling process and the short-termism is permanently vitalized. In the existence of such a trend non would be willing to accept a lower (competitive) rate of return. The cost of capital eventually aggravates the efficiency of the production system - a popular explanation for the

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[24] See Sing (1993).

[25] Keynes used to resebmle stock markets with "casino", on his views and an interesting discussion on the role of stock markets in economic developement, see ibid. Also see Allais (1993) on the speculative moves in the stock market, the demage caused by it and the proposed reforms. For the views of Islamic scholars on the subject one may refer to al Qari (1993).

[26] Oliver E. Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Rational Contracting, NY,* The Free Press, 1985. Qouted in Armen A. Alchian and Susan (1988) *p. 71*.

competitiveness of Japanese bank dominated economy over the relatively stock market oriented US and European economies[27] .

Given the fact that corporations in the developed market economies have met only a small part of their total financing needs (3 % only), the existence of trading in billions of dollars every day is the result of mere speculation. A little more reliance of these companies on such a method of financing could further increase the speculative process and further undermine the competitive basis of the production system. So, the minimum existence of common-stock financing in companies capital structure must be considered as a prudent policy on their part.

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

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

[27]Sing (I993) refers to a MIT study on the subject of competitiveness of US and Japanese industries. The MIT study concludes that as a result of diversification - seeking higher rate of return, the US firms have lost competitivenes to the Japanese.

IV

REDEEMABLE PROFIT AND LOSS SHARING: A COMPREHENSIVE ISLAMIC FINANCING MECHANISM

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

4. 1 ISSUES IN THE REDEEMABILITY OF *MUDHARABAH* AND *MUSHARAKAH*

Are the funds provided under *mudharabah and musharakah* redeemable? Some researchers consider that in their pure forms, these two Islamic modes of financing are redeeming in nature. As redeemability is closely related to the manner in which the principal funds are re-paid, a closer look at the re-payment method of the principal of *mudharabah* and *musharakah* funds is therefore, required. However, before discussing whether these funds are redeemable or not, it is important to describe the specific notion of redeemability of funds as adapted in the paper.

The re-payment of the principal funds depends on the nature of the specific activity which uses the funds in question. Some activities seeking finance are simple and single operation transactions. In such cases, the issue of redeemability is irrelevant as all funds will retire together with the conclusion of the transaction. Whereas, an overwhelming number of contemporary activities seeking finance are in fact inseparable parts of ongoing enterprises. One part of the funds (the permanent equity) of such enterprises cannot be retired. But often, a greater proportion of funds is retired on the basis of contractual agreements about timely planned re-payment schedules.

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

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

Non Redeemability of the Pure *Mudharabah* Funds

In the traditional sense, the principal of the *mudharabah* can be repaid *only* after the calculation of its growth. In general, both the *mudharabah* and *musharakah* enterprises are started with monetary contributions. Hence, calculation of capital growth is possible only when all nonmonetary assets of the enterprise are transformed into money. The amount of monetary increase in the principal funds deployed constitutes profits and a decrease in them losses. This type of calculation of capital growth is a factual rather than hypothetical phenomenon. It is important to note that in case of pure *mudharabah,* this factual calculation of capital growth is a result of conclusion and liquidation of the enterprise. It is therefore, a rule not exception.

Two types of *mudharabas* are known: transaction specific and time specific. Whether the funds are provided for carrying out a specifically identified transaction or provided for nonspecific transaction but for utilization within a specific time frame, with the conclusion of *each mudharabah* the contracting parties depart'. It is only due to this reason, i.e., factual liquidation of each enterprise, factual calculation of capital growth becomes feasible. As the

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

enterprise liquidates, all funds are retired, together. Thus, the funds of pure *mudharabah* and *musharakah,* in fact, resemble the permanent equity of a modem enterprise; hence, nonredeemable.

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

First, most ongoing enterprises periodically prepare balance sheets reflecting their respective depreciation, assets-liabilities and profit-loss positions. Instead of actually liquidating an enterprise for the calculation of capital growth, these estimated evaluation *(tandhid al hukmi)* reports can be treated as the basis for the calculation of capital growth and payment of the *mudharabah* profits[29].

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

Second, if funds are made transaction specific, after evaluation reports, whatever, capital growth is obtained, the funds will be repaid in lump-sum. In other words, the vital importance of gradual retirement of the funds by gradual repayment needs further conceptual investigation. In our understanding, the gradual rather than abrupt repayment of the *mudharabah* funds and profits is of immense importance. We do not need to go into the detail of this obvious point. However, it may be reiterated that gradual re-payment of the funds enables the enterprise to manage its cash flows with ease and efficiency30, among several other benefits.

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

[30]It is note worthy that newer explanations of the firm's capital structure rely mostly on the relative implication of different forms of funds for the firms' cash flows.

Redeemability of Bank Deposits as *Mudharabah* Funds

The deposits' side of the Islamic banks presents an important contemporary example of wide scale utilization of the profit sharing principle underlying *mudharabah.* In many respects, this application has widened the horizon of the traditional concept". The Islamic banks use the *mudharabah* principle as a resource mobilization technique. The bank as a legal entity is one person (mudharib-manager of funds), dealing with numerous suppliers of funds (depositors-owner of funds). It is note worthy that unlike in the original form of *mudharabah*, in case of the deposits of Islamic banks, *in general, PLS deposits are not rigidly linked with the operation of any specific transactions* and depositors withdraw the principal amount of their deposits at wish.". A depositor must wait for the forthcoming evaluation for sharing profits, but can withdraw by foregoing his profit claims for the unevaluated period. We noted earlier that the pure *mudharabah* is in fact a form of business enterprise. In case one party ceases to continue, the enterprise shall also come to an end. While in case of the PLS deposits of Islamic banks, normal withdrawals do not affect the operations of the bank as a *mudharabah* enterprise. In this manner, the deposit side of the Islamic banks is a major departure from the original form of the enterprise, while at the same time using the basic principle of profit and loss sharing.

Conceptually, the depositor-bank relationship is the same as the *rab al mal* and *mudharib* relationship. Keeping in view the condition of an evaluation period for profit claims, PLS depositors, in general, are free to deposit their money at will and to withdraw at will, often, in proportions and amounts of their choice". If we consider the depositors as financiers, their funds can be considered as redeemable capital, as the withdrawal of these in *normal circumstances* will not create any hazard for the banks as ongoing enterprises. This is so because

[31] For a detailed study of the differences between traditional *mudharabah* and contemporary *mudharabah* (deposits' side of Islamic bank), one may refer to al Amin (I991).

[32] We also need to keep in record that al Jarhi (I976) calls for a I00% reserve requirement. Fahmi (forthcoming) calls for the complete abrogation of the present deposit mobilization mechanism of the Islamic banks to conform it with the original principle of *mudharabah.* In this paper we do not aim to discuss this particular issue. Suffice it to emphasize that the deposit mobilization techniques of Islamic banks are almost uniform and it has the approval of the consensus of *sharia 'h* scholars.

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

each PLS deposit is considered as an enterprise in itself. In this way, the Islamic bank is involved in as many enterprises as its *mudharabah* depositors. The cost of a premature liquidation of this typical enterprise for the depositor *(rab al* mal) is negligible because, factually an individual deposit is not specifically linked to any real economic activity; although as a pool, these constitute the bank as an enterprise. The cost of the premature liquidation of a deposit-enterprise for the bank *(mudharib)* is also negligible for the same reasons and for the fact that the depositors are numerous.

Thus, we observe that there is a disguised but an important dichotomy between the contemporary practice of *mudharabah* on the deposit side of Islamic banks on one hand and expected *mudharabah* on -the assets'-side of these banks (for the same reasons between- individual *rab al mal* and *mudharib* related in ongoing enterprises) on the other. The previous case reflects the relevance of banking practices, particularly *tandhid hukmi* for a contemporary Islamic economy and its rightly adaptation as a substitute of factual liquidation in the Islamic framework. The later case (i.e., *mudharabah* in the assets' side of the banks, similarly between individuals savers and ongoing enterprises)34 is the result of continuation of the traditional *mudharabah* conditions (which are though not restricted but were predominantly practiced to finance single transaction trading activities) without adaptation to *tandhid hukmi* as a requirement of operating all contemporary ongoing enterprises. Thus, it can be concluded that, as, through *tandhid hukmi* and linking *mudharabah* deposits (funds) with the general performance of the enterprise (bank) rather than a specific activity in it, the basic principle of profit sharing has been adapted to suite the deposits side of Islamic banks; in principle, it can also be adapted to meet the requirements of non financial ongoing enterprises.

Implications of Redeemability of Finance for Ownership Structure

As emphasized in the opening paragraph of this paper, the essence of PLS financing lies in taking the responsibility of the risk inherent in ownership of assets. In pure *mudharabah* the financier wholly owns the capital of the enterprise and wholly bears the risk of loss of this capital. In pure *musharakah* each party bears the loss of his part of ownership. We concluded that pure *mudharabah* and *musharakah* contracts impose ownership considerations on the firm's financial policy. In other words, the firm cannot acquire funds unless it is

[34] Some Islamic banks are reported to do *musharakah* on daily product basis, which *is* expected *to* improve the cash *flow of* enterprises. However, such arrangements need more *sharia'h* evaluation.

willing to change its ownership structure. A large number of enterprises, obviously, cannot compromise with this condition. As a compromise solution, we proposed that in order to be universally acceptable, the PLS arrangement should be flexible with respect to the longer-run ownership structure of the enterprise. An objection can thus be raised: How can the PLS principle remain neutral with respect to the ownership structure of an enterprise?

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

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

An anonymous *shari 'ah* referee on the earlier version of this paper, explains the *shari 'ah* implication of this arrangement in the following words:, "If the enterprise wants to obtain finance from a person without giving him a share in the ownership of his assets it will not be in accordance with the *shari'ah. However, it may be true that even though the holder of such an instrument will get a share in the assets of the enterprise, yet, because, of the redeemable nature of this instrument, this sharing in the assets will not change the ownership structure of the enterprise in the long* run...In fact no such instrument can be evolved on the basis of *musharakah* which does not give its holder any title to the assets of the enterprise. However, the concept of redeemability can easily reduce the apprehensions of the enterprise against a radical change in their ownership structure in the long-run because whenever the instrument is redeemed by a person his claim to the ownership comes to an end". (emphasis added).

4.2 OUTLINES OF THE PROPOSED REDEEMABLE PLS SCHEME

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

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

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

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

The Proposed Scheme

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

Suppose a small sole proprietorship enterprise, is in need of funds, (for instance, $25,000)[36]. As the enterprise is sole-proprietorship, these funds cannot be extended on the basis of pure *mudharabah* or *musharakah* (the limitations are discussed, particularly, in section 2.2). We propose that these funds can be provided on the basis of redeemable profit and loss sharing. Suppose, the annual evaluation reveals that at the time of seeking the new funds the total net worth of the enterprise was US $75, 000. To this we add US $25, 000 contributed by an individual financier, so that the new PLS enterprise with a present value of $100,000 is established". For simplicity, we also assume that on pro rata basis the two parties share profits and losses in proportion to their capital contribution. As long as the capital contribution remains in this proportion, the entrepreneur will take 75% of total profits and 25% of total profits will accrue to the financier.

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

We assume that both parties complete all formalities which are required for implementing *a musharakah* contract[38]. In addition, we make the following important considerations.

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36 The literature on informal finance in the developing countries gives the impression that interest-based informal lending exists in all developing countries including Muslim countries. This author has discussed the matter with relevant researchers. All maintain the position that Muslims do not charge interest on inter-personal loans.

37 We notice that the enterprise in question is *a mudharabah* enterprise in a restrictive sense.

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

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

Second, to calculate capital growth, the contract recognizes the annual evaluation (audit) reports as a perfect substitute of factual liquidation.

Third, the contract stipulates that in case of profits a certain part say $5000 of the financier's funds will be retired on yearly basis, in case of loss in yearly operations, nothing will be retired. In this way, the contract will also specify that PLS contract in the first year will be based on capital contribution in 25% ($25,000), 75% ($75,000) proportion respectively, by the financier and entrepreneur. In the second year, after re-payment of $ 5000, of the principal amount, the capital contribution in the enterprise will change to 20%, 80%; I5%, 85% in the third year; I0%, 90% in the fourth year and 5%, 95% in the fifth year. The profits will be shared each year in proportion to the capital contribution relevant for that year. However, with adjustment for losses in some years, this schedule may not be strictly observed (see, Table-I for the maturity of a hypothetical redeemable PLS contract).

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

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

Thus it can be expected that using this mechanism the enterprise can meet its financing needs to expand without involving in *riba* and without compromising its longer-term ownership preferences. The case can further be generalized. Suppose, the above funds were acquired and the new enterprise established on 1-I-I4I4H with the present value of $100,000. Since, this enterprise does not restrict the entrepreneur to mobilize additional funds, on I-I-I4I5H, after the first annual audit report, the entrepreneur may acquire more funds on conditions mentioned above to expand the enterprise further.

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[39] This arrangement may also take the following form. At the time of establishing the enterprise, the financier will contractually agree to sell his share in the enterprise gradually to the entrepreneur at prices prevailing at the time of each sale. The entrepreneur may however, buy (as assumed in the present case) or not buy at his own free will.

Table-1

Maturity of a hypothetical Redeemable PLS Contract

(assumptions: no taxes, no depreciation, no interest payments).

First Year	
Total Net worth of Enterprise	$75,000
Total Line of PLS	$25,000
Present Value of the Enterprise	$100,000
End of Year Operating Profits (7%)	$7000
Financier's share in total profits (25%)	$1750
Entrepreneur's share in total profits (75%)	$5250
Principal re-payments (profit retention)	$5000
Second Year	
Total Net worth of the enterprise	$80,000
($75 ,000+$5000 retained profits)	
Total Bank Finance outstanding	$20,000
($25,000-$5000)	
Present value of the enterprise	$100,000
End of year Operating Loss (3%)	
Financier's share in losses (20%)	$600
Entrepreneur's share in loss (80%)	$2400
(As contractually agreed, no principal repayments will be made)	
Third Year	
Total Net worth of the enterprise	$77,600
(80,000-$2400 entrepreneur's loss)	
Total bank finance outstanding	$19,400
($20,000 - $600)	
Present value of the enterprise	$97,000
End of year Operating Profits (9%)	$8730
Share of the financier in profits (20%)	$1746
Entrepreneur's share in profits (80%)	$6984
Principal repayments	$5000
Fourth Year	
Total Net worth of the enterprise	$82600
($77,600+$5000 retained profits)	
Total Bank Finance outstanding	$14400
Present value of the enterprise	$97000
End of year operating profits (11%)	$10670
Share of financier in profits (15%)	$1600.5
Share of entrepreneur in profits (85%)	$9069.5
Principal re-payments	$5000
Fifth Year	
Total Net worth of the enterprise	$876000
Total Bank Finance outstanding	$9400
Total present value of the enterprise	
End of year operating losses (4%)	$3880
Share of financier in losses (9.7%)	$376.4
Share of entrepreneur in losses (90.35%)	$3503.6
Principal re-payments	$5000
Sixth Year	
Total net worth of the enterprise	$84096.4
Total Bank Finance outstanding	$9023.6
Total present value of the enterprise	$93120
Operating profits (13%)	$12105.6
Share of financier in profits (9.7%)	$1174
Share of entrepreneur in profits (92.3%)	$10931
Principal re-payments	$5000
Seventh Year	
Total net worth of the enterprise	$89096
Total Bank finance outstanding	$4023
Total present value of the enterprise	$93120
End of year operating profits (11 %)	$10243
Share of financier in profits (4.32%)	$442.5
Share of entrepreneur in profits (95.68)	$9800.5
Principal re-payments	$4032
Total net worth of the enterprise	$93128
Total outside finance (ownership) outstanding NI	

Thus, a continuous flow of PLS funds can be generated. Retiring funds will continuously be replaced by new funds without any rigid conditions imposed on the ownership structure of the enterprise. The door for utilization of entrepreneurial skills, which is now stagnated, in the Muslim countries, can be made dynamic by removing the financial constraint'". With these broad outlines of the proposed scheme, we now turn to discuss the implications of the specific scheme

Some Implications

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

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

Policy makers in the Muslim countries may benefit from the experience of finance and industry relationship as exists in Japan and Germany. As it is well

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

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

Furthermore, the scheme is also expected to enhance managerial incentives as compared to permanent PLS as it ultimately strengthens internal ownership of the enterprise. In addition, the scheme also overcomes the inevitable domination of the economic system by financial institutions under the permanent PLS. This matter is of immense importance viewed in context of mobilization of external finance for the resource scarce Muslim countries. As compared to permanent PLS, redeemable PLS does not endanger the host economies to external domination in the longer-run.

Preservation of Capital

In general, investors staking in the short and medium-term operational outcome of an enterprise i.e., the owners of the temporary equity, confront more risks compared to the permanent equity holders and owners of its debt. For this reason, the owners of the enterprise give a preferential treatment to the suppliers of the temporary risk capital.

The matter of preservation of the PLS funds is an elaborated concern in the relevant literature. The user of funds are directly held responsible for capital loss due to avoidable circumstances. Institutional arrangements are needed to overcome losses to the PLS funds of an enterprise due to unavoidable circumstances.

There may be a number of possibilities of such arrangements. For instance, the permanent PLS as well as the temporary PLS owners in an enterprise may develop a capital preservation fund. The two parties (owners of permanent and temporary PLS funds) may contractually agree to deposit a particular percentage of their share of profits to this fund. The fund will be used for two purposes: to equalize and stabilize profits and to offset losses to the principal capital. The IDB Unit Investment Fund has adopted the method of "dividend equalization account" (DEA). The DEA is a pool of funds to which contributions are made by unit holders out of their dividends in a particular year. The objective of the DEA is to offer a stable rate of return comparable to other investment opportunities in the risk class of the UIF. In exceptionally high dividend year the DEA will expand and during low performance funds will be drawn from the DEA to maintain a stable stream of dividend flows. A similar concept was also used by the Kuwait Finance House during 1982 when the KFH suffered losses and depositors were not paid any profits. But the permanent owners of the KFH compensated the temporary PLS financiers (depositors) during I984 when the KFH recorded good profits.

Similar arrangements are not only relevant but also suitable in case of the proposed scheme. Moreover, the *shari'ah* experts also recognize a third party guarantee of the principal PLS funds as discussed in the next section.

V

INVOKING SUPPORT FOR REDEEMABLE PLS

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

5.1 A LESSON FROM FINANCING *A WQAF* PROPERTIES

A waqf is a legal person. Its property cannot be owned but by itself. This implies that the *warf* cannot be financed on the basis of the *mudharabah.* Also, the *waqf* property cannot be shared by others. This implies that the permanent *musharakah* also is not a convenient financing technique as the *waqf will* become a permanent partnership (the waqf may however, manage its current assets with doing short-term *musharakahs).* This financing problem is a typical example of a situation where the need for a comprehensive Islamic financing mechanism outlined in the previous section of the paper emerges. The example is generally valid. Therefore, a solution put forward to overcome this typical problem, can also be valid for all such cases where generalization of the problem is possible. To overcome the typical problem, the *Muqarada* Bonds' Act I98I was introduced by the Government of the Kingdom of Jordan under supervision of a *shari 'ah* board comprised of prominent *shari 'ah* scholars.

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

It is noticeable that the law was enacted under the supervision of a *Fatwa* committee. Therefore, *a shari'ah* evaluation of the legislation is not in the competence of the present paper[41,42] .

5.2 A LESSON FROM FINANCIAL ISLAMIZATION IN PAKISTAN

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

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

However, as practiced by companies under trusteeship of the Bankers Equity Limited, the PTC arrangement have certain features which are objected by

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

[42]However, for role of a third party guarantee one may refer to the OIC Fiqh Academy Resolution regarding Muqarada Bonds for *sharia'h* observations on the legislation discussed in section 5.4.

[43]See *Council of Islamic Ideology* (1981)

the *shari'ah* scholars, such as: i) The assets of the issuing firms are kept as a collateral against the principal amount of the PTCs, ii) The principal amount also includes, the discounted values of the PTC funds for the grace 'period of the enterprise (if it is new) and iii) In case of loss, the bondholders through their trustee, will have a recourse to the bank accounts and other assets of the issuing enterprises.

5.3 A LESSON FROM ISLAMIC BANKS AND MUDHARABAH COMPANIES

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

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

The contemporary practical cases of the redeemable PLS have in fact opened a new dimension in the field of practicing Islamic principles of financing. There are numerous cases, where in fact, such a redeemable nature of financing is of paramount importance4[5]. The redeemable techniques of financing have also been suggested as probable Islamic mode of financing for *Awqaf* properties[46] as well as for Islamizing the capital structure of the companies47 .

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[44]Amin (I990) discusses several of these issues from the *shari h* perspective.
[45]For more details see Khan and BenDjilali (1993).
[46] See IDB (1987)
[47] IDB (I994)

5.4 ROLE OF THE GOVERNMENT

In the proposed and practical cases of redeemable PLS outlined above the principal amount of the finance is almost guaranteed. An objection may be raised against such an arrangement. If the principal amount is guaranteed, the contract would be *a qard* (loan) contract. In such a case, there is no justification for the financiers' share in profits. Provided that there is no third party guarantor such an objection is a valid one. But, a third party (a party having no stake in the enterprise) guarantee for the re-payment of the principal amount of a PLS fund is visualized and legitimized by the Islamic scholars48. Such a guarantee of the principal amount does not transform the character of the contract from sharing to *qard.* If the principal is re-paid as guaranteed, in most contracts, the user of funds would prefer to pay in installments.

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

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

[48] See Kalif (1989), Siddiqi (1993) The OIC Fiqh Academy (1989)

the bondholders. For all practical purposes, the Banker's Equity almost functions in similar manner.

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

VI

ELEMENTS OF GROWTH OF AN ENTERPRISE

In previous sections of the paper it is argued that it is possible to visualize a comprehensive financing mechanism in Islamic economics, which can meet the cash requirements of firms without causing any unwanted change in their longer-run ownership structure. The present section intends to argue that such an arrangement is also inevitable for the growth of enterprises under the PLS system.

6.1 RELATIONSHIP OF GROWTH WITH RETENTION AND RATE OF RETURN ON EQUITY

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

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

The more an enterprise retains and re-invests, the greater is its capital base, the higher is its potential for growth. Given the capital base, the higher is the rate of return on this capital, the higher would be the growth rate of the enterprise. Growth (g) of an enterprise is thus defined as: percentage of earnings retained (R) times return on equity (ROE); i.e., g = R X ROE49. If R=O, the capital base of the firm will remain constant, whatever the ROE may be, the growth of the firm would be constant. In the same manner, the ROE is extremely

[49] For an earlier formal model on the implications of retained profits for growth of a "managerial enterprise" one may refer to Marris, R. (I963) discussed in Chapter-I6 of Koutsoyiannis, A (1979).

important. If it is zero, R cannot be positive, naturally the growth of the enterprise would not be positive.

Traditionally, there are two methods to look at the ROE: the operational side of the enterprise and its financial policy. The first method uses the operational side of the firm to define the ROE. In this case the

$$ROE = \frac{netIncome}{CommonEquity} = \frac{NetIncome}{NetSales} \quad \frac{netSales}{CommonEquity}$$

This definition implies that the return on equity can be improved, either by producing more - increasing the equity turnover (using the equity more efficiently) or by increasing the enterprise's net profit margin by arranging to become more profitable. Both the two relate to the operation of the enterprise. By using this method, higher ROE will lead to an increase in capital base, only if a nonzero fraction of it is retained and re-invested in the enterprise. This way of looking at the ROE is related to the operational side, such as production and marketing policies of the firm.

The ROE however, increases the capital base of an enterprise in a more direct form through its financial policy. The second method expresses the ROE as a result of the financial policy of an enterprise. The ROE can be increased by increasing the capital base of the enterprise by asset acquisition through borrowing. In the traditional sense, therefore, increasing the financial leverage of the enterprise i.e., by acquiring more assets through borrowing, the ROE can be improved. The method expresses the ROE as:

$$ROE = \frac{NetIncome}{Equity} = \frac{Sales}{TotalAssets} \; x \; \frac{TotalAssets}{Equity}$$

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

6.2 RELATIVE VARIABILITY OF RETENTION AND GEARING - BASED GROWTH

Retention and financial policy component of the ROE (financial leverage of the enterprise) are important factors contributing to the growth of an enterprise. Nevertheless, retention-based growth is more stable compared to debt-based growth. As retention expands the shareholders equity in the enterprise, this leads to the conclusion that equity based growth is more stable than debt-based growth. Table-2, provides mean, median and standard deviation values for self financing, ROE and gearing for various sectors of the Pakistani economy for the I980-9I period. Based on this data the growth and variability of growth is calculated for the sectors in question. Some observations must be made on this data: i) By definition, industries grew either by high retention, or by high leverage or by both - growth industries such as, the chemicals sector relied less on debt but retained a substantial part of its earnings, paper industry relied more on debt than on retention, sugar depended on high rate of retention. Zero growth industries - textiles and transport borrowed substantially, but their ROE was very low suggesting operational losses, ii) In average, transport, textile, paper and cement industries which relied more on debt experienced unstable growth. Energy is the only sector which relied more on debt but experienced -a stable growth, an explanation to be seen in the stable demand for the products of this sector, iii) In general, therefore, industries relying more on debt experienced unstable and lower growth, whereas, industries relying more on retention (shareholders' equity) experienced stable and higher growth.

Table-2

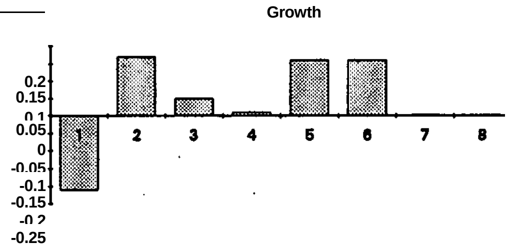
Mean, Median and Standard Deviation Values of Major Financial variables for Pakistan % (1980-91)

SECTORS	ROE								
	Mean	Median	STD DEV	Mean	Median	ST)) DEV	Mean	Median	STD DEV
Cement	18.444	17.175	6.008	41.234	43.275	7.907	- 1.19024	8.085	386.307
Chemicals	34.93	34.875	4.249	25.988	26.02	7.581	0.49393	40.9	31.243
Energy	16.827	16.965	2.035	51.368	51.165	3.216	0.27403	23.705	14.701
Engineering	19.443	18.215	7.834	34.78	32.81	7.727	0.07527	5.82	16.717
Paper	38.961	18.75	42.18	65.27	65.97	11.958.	0.41599	26.92	75.189
Sugar	22.137	25.375	11.729	23.897	25.825	12.289	0.7255	40.96	95.924
Textiles	2.029	10.565	41.452	58.708	56.025	11.846	0.15142	18.32	94.288
Transport	2.236	4.07	13.97	56.507	60.425	11.049	0.24709	11.8	38.076
Private	22.5	23.5	4.87	38.167	39	5.508	0.16833	18	16.814
Public	13.083	14	3.679	52.833	52.5	3.243	0.16333		21.197

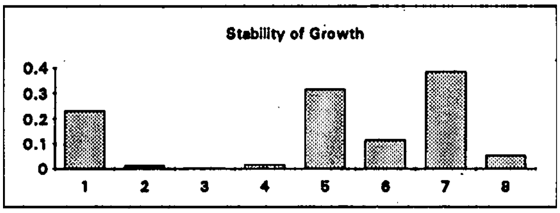
ROE: Return on Equity. Gearing: Total fixed liabilities as % of total capital employed. *SFR:* Self financing ratio (retention in business as % of capital employed.

Source: Data extracted from the sources of State Bank of Pakistan

Growth: Mean Values 1980-91	SFR	ROE	Growth
1.Cement	-1.19	0.18	-0.21
2.Chemicals	0.494	0.35	0.17
3.Energy	0.274	0.17	0.05
4.Engineering	0.075	0.19	0.01
5.Paper	0.42	0.39	0.18
8.Sugar	0.73	0.22	0.18
7.Textiles	0.15	0.02	0.001
8.Transport	0.25	0.02	0.001



Stability of Growth: STD for 1980-91	SFR	ROE	SGrowth
1.Cement	3.87	0.08	0.2322
2.Chemicals	0.31	0.04	0.0124
3.Energy	0.15	0.02	0.003
4.Engineering	0.17	0.08	0.0136
5.Paper	0.75	0.42	0.315
6.Sugar	0.98	0.12	0.1152
7.Textiles	0.94	0.41	0.3854
8.Transport	0.38	0.14	0.0532



Explanations:

SFR: Self Financing Ratio (retention as % of Increase/decrease In capital employed) ROE:

Return on Shareholder's Equity

Growth: Growth Rate of Earnings (growth of the company) - SFRxROE

SGrowth: Stability of Growth - STD of SFRxSTD of ROE

STD: Standard Deviation

6.3 EFFECTS OF REDEEMABLE PLS ON THE ROE

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

So, the fault of debt financing lies in its separation of risks from ownership and concentrating them on the capital base of the enterprise. A mechanism, which can help enterprises to acquire assets but at the same time can minimize their financial risks can be superior to debt. The proposed redeemable

PLS arrangement ensures asset acquisition by the enterprise in the same manner as the mark-up does. But unlike under the debt financing mechanism, under the redeemable PLS, financiers will not have any fixed claims on the acquired assets. Thus, the question of bankruptcy and the related costs will not arise. Hence, the redeemable PLS arrangement has the capability to ensure asset acquisition, i.e., expand ROE, but without increasing the financial risk of the enterprise.

6.4 EFFECTS OF REDEEMABLE PLS ON PROFIT RETENTION

Retention of profits promotes self financing, thus, in general, enables enterprises to stand more on their own as ongoing entities. In the traditional ***musharakah-mudharabah*** contracts, capital contribution by parties and the resultant profit sharing ratios are defined once for all. The typical example is *mudharabah* in which all funds are provided by one party. If total ownership of an enterprise is designated as 0, where entrepreneur shares 0_1 and financier 02. In the general case of pure *mudharabah*, by definition**,** 0_1 is always zero, so that 0_2 equals one **-** the enterprise is wholly owned by the financier. For simplicity, let us rely on this general case. This is due to the fact that in its most common practice,. the *mudharabah* has been a one transaction business enterprise. At the conclusion of the transaction, growth in the initial capital is calculated for distribution as agreed on pro rata basis. In other words, it is very rare to find historical practical evidence of *mudharabah* as an ongoing enterprise, despite its theoretical possibility.

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

The proof of this assertion is quite simple. First, to make the question of retention relevant, the enterprise itself must be made an ongoing activity. Second, through *tandhid al hukmi* (hypothetical presumed liquidation), the exact cash value of the enterprise must be calculated, capital growth identified, and literally another *mudharabah* enterprise established, with negotiations on profit sharing ratios etc. Each time if retention is considered, the procedure must be repeated. Each time the size of 02 will increase as a result of re-invested profits but 0_1 will remain zero as implied by the *mudharabah* contract.

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

Suppose, the entrepreneur is allowed a free choice to re-invest his savings in the enterprise under his management. Suppose it is a rational decision for him to retain profits and share ownership in the enterprise. Once profits are declared, the entrepreneur must have non-zero share in the enterprise implying a positive 01, consequently 02 would become fractional. The *mudharabah is* thus transformed into another form of enterprise - *musharakah.* If the process continues, at the extreme, the enterprise will transform into sole proprietorship owned by the owner-manager[50] Redeemable PLS incorporates this vital consideration and allows for profit retention by the entrepreneur.

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

Under *musharakah* however, the retention of profits becomes a management decision. This is analogous with the case of joint stock companies[51] . Under these circumstances, profit retention by an enterprise can be enhanced by designing financial mechanism which is biased in favor of retention rather than high distribution *of* dividends. By definition the redeemable PLS mechanism enhances retention *of* profits.

[50]Khan and Boulem (1993) have undertaken an analysis of the policy implications of this Premises for poverty alleviation in the Muslim countries.

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

VII

TOWARD ENHANCING THE CASH FLOW OF ISLAMIZING ENTERPRISES

It is argued in the paper that capital participation in enterprises is possible only through the *mudharabah* and *mudharabah* modes of Islamic financing. To enhance participatory capital in enterprises, a redeemable form of PLS financing which is more flexible in relation to ownership structure of enterprises is proposed in previous sections of the paper. The present section aims at discussing the prospects of enhancing the cash flow of Islamizing enterprises. This exercise is also valid for enterprises which look for resource mobilization from the markets in consistency with the *shari'ah.*

Depending on their attitude to risk, some financiers may prefer capital participation, and others avoid it and resort to markup and other fixed return investments. There must also be a wide spectrum of investors whose risk profile require investment opportunities between the two extremes. Moreover, for the purpose of capital participation, some financiers would like to wait and see the outcome of an attempted effort at Islamization of the capital structure of an enterprise. If these propositions are true, there is a need for financial instruments which can meet the preferences of the wide group of investors. Hence, enterprises can also attract more participatory capital from financiers by attaching incentives with their requests for the installment purchase mode of financing.

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

Moreover, there is an interest-based debt in its capital structure which drives away the Islamic investors.

The enterprise can however raise finance by deferred or more specifically installment purchase arrangements. This mechanism relieves the enterprise's presently available funds for more urgent uses improving its cash flow conditions indirectly. The more flexible the re-payment schedule, the better its implications for the cash flow of the enterprise. Hence, in general, enterprises bargain on prolonging the re-payment period as it improves their cash flow conditions. It is natural that the longer the re-payment period, the higher the mark-up is expected to be. Thus it is natural for enterprises to seek installment purchase financing for a longer period but at the lowest possible markup.

In its prevailing depressed circumstances the typical enterprise cannot also raise installment purchase financing at a suitable mark-up. In fact, the enterprises need long-term funds. Suppose, the enterprise can be made profitable if installment purchase worth dollars 10 million can be made available at 6% mark-up with a maturity of I5 years. The financiers are willing to provide the required financing with the required time of maturity, but only at II% mark-up[52].

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

7.1 **THE OPTION TO PURCHASE COMMON STOCK**

To get the required finance at the required conditions, the enterprise can bargain with the financiers. As a part of this bargain, the enterprise may offer an open option to the financiers to purchase the common stock of the enterprise in future at a price specified at present (the time of the contract). As the present

52 Among other things the mark-up rate can depend on the re-payment time. For example, in the IDB the mark on finance provided under the Import Trade Financing scheme where the repayment time ranges between 9 to 24 months, the markup ranges between 6-6.5%. While under the installment sale scheme, the where the repayment takes upto I2 years, the mark-up ranges between 7.5-8.5%. Whereas, under both schemes a rebate of 15% is given out of the outstanding markup for quick repayment (See IDB Brochures on the two schemes, both dated September 1993).

market value of one share is dollars 9, it will be specified in the contract that if he so desires, the financier can buy a specified amount of common stock from the enterprise at suppose, dollars I2 per share during a specified future date. It may be noted that The OIC Fiqh Academy Resolution concerning *Muqarada* bonds permits some form of future promise, provided it is binding on only one party. In the present case, the option to purchase is not binding on the financier, but the promise to sell is binding on the enterprise. Thus the proposed contract, in spirit, does not seem to violate the resolution.

There are several justifications for putting the future offer price higher than the present market price. First, the owners of the enterprise have the right to fix the price of their property. Second, by raising the asset base of the enterprise with the responsibility for the dollars I0 million installment purchase liabilities, the future price of the enterprise must be higher compared to the price prevailing prior to the addition of this amount. Lastly, the financier is at its free will to purchase or not to purchase in the future.

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

By considering the offer as an investment avenue, the financier considers an opportunity to invest in a real project. The expected growth potential of this enterprise is high. The stock which the investor will buy at dollars I2 may thus be sold at further higher prices in the future. Moreover, by buying these stocks, the financier will actually be pumping more cash into the enterprise, improving the prospects of the enterprise to pay the installment purchase liabilities more efficiently. The financier would also avoid the dividend taxes which he must pay in case of outright purchase of such stocks which announce dividends. The financier can also motivate the firm to replace interest-based debt from its capital structure, thus enhancing Islamic investment opportunities.

7.2 THE OPTION TO CONVERT LIABILITIES INTO COMMON STOCK

The second point at which the enterprise can bargain with the financier for favorable conditions of financing is the option to convert the installment purchase liabilities into common stock of the enterprise. Again, at the time of the initial contract, the enterprise may offer to the financier that at his own will the financier may convert a specified part of its liabilities into the common stock of the enterprise at a specified higher price compared to prevailing market price.

It may be noted that this proposal resembles a situation where debt is considered as a principal in *mudharabah/musharakah.* The *shari 'ah* scholars have discussed this issue in detail. Specifically, can the owner of a debt tell the indebted person to do *mudharabah* with the amount of debt which he owes. The Malkites and Shafites do not permit this arrangement, but the Hanbalites and Hanfites permit it". The concern of the scholars who disapprove this arrangement is understandable in case the indebted person is an individual and his net worth is not clearly known. But in case of an established enterprise with a known asset base, an enterprise to which the financier itself has sold on installment credit, the flexibility of the scholars who permit the arrangement seems to be more useful.

The benefits of this arrangement for the enterprise are the same as in the case of an option to purchase the common stock of the enterprise, except that this arrangement does not improve the cash flow situation directly. But since it improves the equity base of the enterprise, the enterprise can raise more financing easily. Hence, cash flow of the enterprise is indirectly improved. The advantages for the financier are almost the same as discussed in the previous case.

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

[53] *See Mausua' a! Fiqhyal Islami*

7.3 SOME CRITICAL POINTS

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

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

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

Third, how to determine the actual conversion prices, in particular, if a market for such options is restricted.

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

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

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

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

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

VIII

CONCLUSIONS AND IMPLICATIONS

8.1 ONCLUSIONS

The OIC Fiqh Academy Resolution which bans participation in the capital of such companies which carry interest-based funds in their capital structure, apparently, seams to be very restrictive. The implication of this resolution, which is specifically related to the activities of the Islamic banks is generalized in this paper. It is argued that in reality the resolution is not restrictive. Because, there must be hundreds of thousands of enterprises in the Muslim world which may not have interest-based funds in their capital structure. Many of these enterprises must be looking for funds in conformity with the *shari'ah* requirements. But due to their preference for strong internal ownership, these enterprises may be in difficulty to compromise with the ownership structure underlying *mudharabah* and *musharakah* arrangements. In, addition, the emergence of *mudharabah* companies, for instance in Pakistan', can be cited as an example where capital participation in the framework of the Resolution must be possible. By imposing the restriction, the Academy has in fact patronized the evolution and development of interest free enterprises.

Given this framework, the paper suggested that the problem of capital participation in enterprises is in fact a problem of devising a comprehensive Islamic financing mechanism - a mechanism which can provide financial accommodation in the form of money, but simultaneously remain neutral to the longer-run ownership structure of the enterprise. Redeemability of profit and loss sharing Islamic financial instruments meet these requirements. Subject to the profitability of the enterprise, a redeemable instrument will facilitate the repayment of the principal amount of finance in installments and profits as agreed on pro rata basis. Thus, finance will remain neutral to the ownership structure of the enterprise in the longer-run.

In this manner Islamic banks as well as individual savers will be able to participate even in the capital of the hundreds and thousands of sole proprietorship enterprises. Once a comprehensive Islamic financing mechanism is

[54] The first draft of this paper contained a section on these companies. As suggested by one referee, the section is removed from the paper. However, the subject is being

covered in a separate paper by the author.

provided, the infant 'enterprises are expected to have a proper environment to avoid interest while financing their growth. On the other hand, in the absence of such a mechanism, generally 'only such enterprises would grow comparatively more which are indifferent to the form of finance. Once grown in such a manner it would always be relatively difficult for them to change their capital structure to conform to the elimination of interest.

Enterprises opting to operate in an Islamic financial environment can mobilize resources by offering participation in their over-all portfolio. Often such financing arrangements lead to non-financial considerations such as control of ownership. Resource mobilization requirements of the closely hold enterprises and some non-depository Islamic financial institutions are unique as these cannot compromise on the control of ownership. The present paper argued that such conflicts between resource mobilization requirements and control of ownership can however, be overcome by issuing redeemable profit and loss sharing financial instruments. Various aspects of this proposal are discussed in the paper.

8.2 IMPLICATIONS

The analysis of the paper has several implications which could be of interest to policy makers as well as academicians. In the following, major policy and research implications of the discussion are summarized.

First, since the OIC Fiqh Academy resolution referred to in the paper prohibits participation in the capital of leveraged enterprises, it may be taken as an encouragement to perpetuate the very limited use of the PLS by the Islamic banks. Our analysis suggests that such an implication would be unjustified, as there may be hundreds of thousands of sole proprietorship enterprises which are not leveraged and which need Islamic forms of funds for growth. Capital participation in such small enterprises also is consistent with the philosophy of the Islamic finance movement.

Second, the paper discussed the form of the PLS which is suitable for the ongoing enterprises. This form is consistent with the deposit side of Islamic banks and efforts in Islamic legislation in some Muslim countries. Hence, the allegation that Islamic financing cannot meet the requirements of sole proprietorships is base less. Nevertheless, the benefits of the proposed redeemability requirement lies in its acceptance by the common people. This requires a close scrutiny of the ideas presented in this paper by Islamic scholars who have the knowledge of the *shari'ah* and who can gauge the financial requirements of modern ongoing enterprises.

Third, the paper has also raised issues related to the need of profit retention and rate of return on equity for the growth of the firm. Implications of retention, self financing and ROE for growth are ignored matters in the literature on Islamic financing. The brief arguments raised in the paper seek conscious policies to enhance retention and self financing by enterprise. For Islamic enterprises this strategy could even work as a shield against interest. A mode of finance which allows retention will also enhance entrepreneurial incentives and efficiency.

Fourth, Islamic enterprises which purchase and lease or sell equipments can substantially enhance their cash flows by resorting to installment purchase instead of their present practices of lump sum payments. In this way, they can enhance their ROE - thus, use their equity more efficiently. In the same context, to subordinate any installment purchase to the PLS, the paper proposed two options as examples. These options coupled with the desire for installment purchase, can be instrumental in mobilizing additional funds on the basis of capital participation.

Fifth, the redeeming PLS can be effectively used for the promotion of entrepreneurs and projects. Islamic banks can undertake projects with infant entrepreneurs and gradually transfer their sole ownership to the entrepreneurs.

Sixth, the arguments raised in the present paper have several research implications, particularly in the field of Islamic corporate finance. Most proponents of the PLS have been caught between two opposing approaches; to argue for the superiority of the PLS within the framework of the Miller-Modigliani propositions (see, e.g., Uthman I994). According to the MM framework, the nature of finance is irrelevant for the efficiency of the firm. This broadly implies that there is a dichotomy between the real and financial sectors of the economy. Whereas, most works dealing with the PLS (see, e.g., Siddiqi *I983,* I9831r and Chapra I985) strongly argue that the PLS has favorable implications for the real sector of the economy.

Thus, there is a need to review or even give up the MM framework for analyzing the problems of Islamic financing. This will have implications for the debate on capital structure of the firm within the framework of Islamic financing. As suggested above, many Islamic enterprises can improve their present cash flows (thus efficiency) by resorting to for instance, installment purchase and at the same time offer capital participation. These and related policy considerations particularly, various options to subordinate the sale-based finance to the PLS constitute potential research areas. Moreover, the subject of growth, self financing, retention of profits, consequences of the ROE, the empirical dimension of the subject, all need indept studies.

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Contenk/r

ISLAMIC DEVELOPMENT BANK (IDB)

Establishment of the Bank

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

Purpose

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

Functions

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

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

Membership

The present membership of the Bank consists of 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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