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## **Incentive-compatible sukukmusharkah for private sector funding: cOMMENT**

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## **Incentive-compatible sukukmusharakah for private sector funding**

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### **Comment**

Zubair Hasan

The article under reference is interesting and has some seminal ideas. Reviewing the contents of the paper is not the objective of this brief note. The intention essentially is to keep the record straight. The authors raise, in a measure, the ticklish issue of “difference between Islamic financing in theory and practice” that keeps engaging the attention of writers on Islamic finance so frequently. While theory demands risk sharing in business ventures, banks largely use fixed return modes in Islamic finance. The article under reference addresses the issue with regard to sukuk as a mode of project financing. However, in the process it makes some observations on my profit sharing ratios’ determination which I find untenable.

We shall discuss three of the issues raised in the paper to clarify our position: (i) agency problem in mudaraba financing, (ii) the workings of profit sharing mechanism and (iii) the role that interest plays in the determination of profit sharing ratios in a dual financing system.

We may begin with some prefacing remarks to avoid semantic confusion. The distinction between musharakah and mudaraba is not well established in the literature on Islamic finance. Even in fiqhi discussions their distinguishing features remain untouched or at best unclear. The terms are often used interchangeably (See for example Usmani 2010). In the following argument we shall employ mudaraba (conditions) for both.

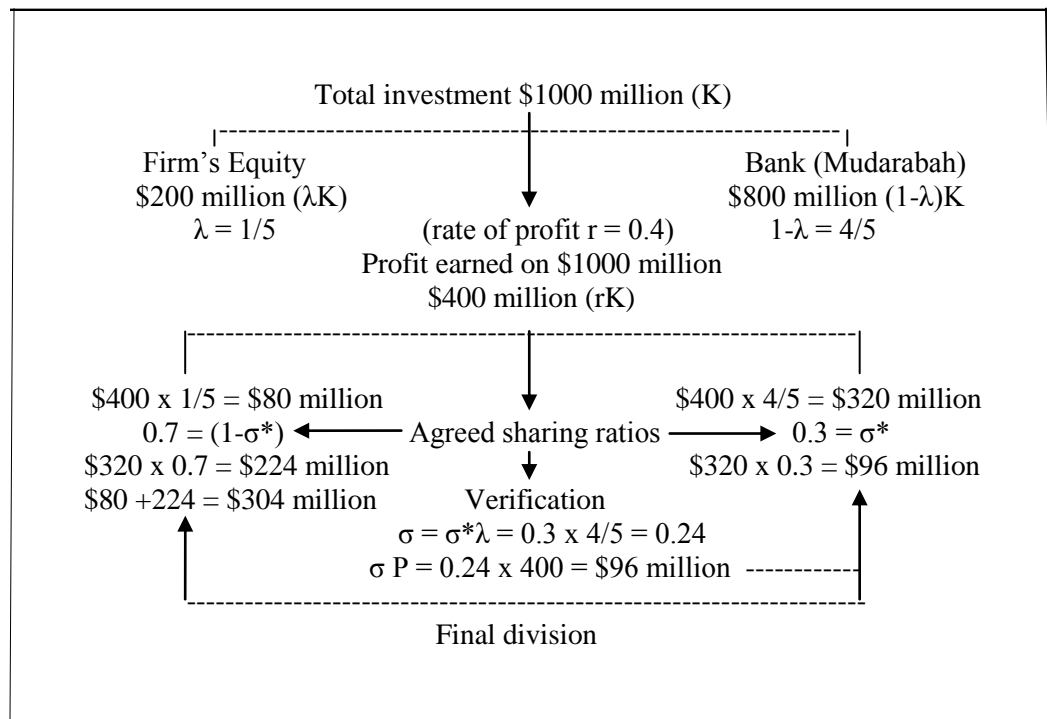
Some writers blame in main the agency problems for the banks’ reluctance to using mudaraba as a financing mode. One need not deny the existence of the problem but to highlight it as the focal factor overriding others to account for mudaraba unpopularity with the banks looks rather overstretched. Presumably, the changing attitudes, structures and environs that characterize socio-economic dynamism in recent times have greater explanatory significance.

Agency problems refer to self-seeking on the part of individuals or their groups at the expense of others in a chain of organizational relationships forged for promoting collective benefits and sharing the same equitably. Agency problems, big or small, are scattered throughout the hierarchic structure of modern corporations and their nexus with the socio-political influence centres in no longer a secret. The literature is awash with illustrations of agency-induced tensions between managers and shareholders, between owners and their employees, between shareholders and corporate creditors, between politicians and contract-seeking businesses ad infinitum. The roots of agency problems lie deep in asymmetric information, tilted power structures and rampant moral degradation. These factors are indeed the germ-carriers of recurring financial crises, of mega bank failures, and now of increasing state bankruptcies. Agency problem is needlessly overblown in case of mudaraba (See for example Bacha 1997).

Mudaraba is of two types: pure or mixed. The puritan form is rooted in the classical fiqh and rests on the assumption that the entrepreneur (firm) is empty-handed; the financier (bank)

provides all the capital for business. Candidly, the two share the loss if any in a 0:1 ratio. The larger portion of profit goes to the entrepreneur; the Malikis explicitly allow no more than 50% share to the financier (Hasan 1985).

However, the real romance of the PLS programs one finds in the mixed mudaraba models of the recent origin. Here, part of the capital investment the firm commits to the project; the other part comes from the financing bank. Losses the parties must always share in the same ratio as their capital contributions. Thus, the profit sharing ratio alone is negotiable between the parties. Also, the negotiation is with reference to that part of profit only which is allocable to the portion of capital provided by the financing bank. In other words, if  $\lambda$  is the proportion of bank finance in the total capital  $K$ , then of the profit  $P$  only the amount  $\lambda P$  would be the subject matter for the sharing negotiations between the parties. If they agree that the bank would get  $\sigma^*$  portion then  $\sigma^* \lambda P$  amount will go to the bank. If we put  $\sigma P = \sigma^* \lambda P$  then  $\sigma$  can be defined as the fraction of the *total* profit  $P$  the bank would get. It comes about that,  $\sigma = \sigma^* \lambda$ . As each of  $\sigma^*$  and  $\lambda$  is less than 1,  $\sigma$  must be less than  $\lambda$ . We have used  $\sigma$  in our papers in addition to  $\sigma^*$  for exploring the macro relationships underpinning the models (Hasan 1985). The table below makes clear the difference between and the relationship of the two versions.



**Figure 1:** Profit sharing process under mudarabah in a dual financing system,

The authors referring to Hasan 2002 paper observe “The model was built under the assumption that the profit sharing ratio of the financier cannot be greater than his loss sharing ratio” (P.47). This is at once untrue. The authors do not provide any documentation on the point. They failed to see that two concepts of the sharing ratio have been used in our papers: one ( $\sigma^*$ ) for the firm level analysis and the other ( $\sigma$ ) for macro level manipulations. Please see the above illustration inserted for the purpose. Here,  $\sigma^*$  is the firm level profit sharing ratio for the bank which could be greater or smaller than the loss

sharing or leverage ratio  $\lambda$ . In contrast,  $\sigma$  is the instrument for the macro level explanations and must be less than  $\lambda$  analytically, not by assumption.

The article further comments: “the interest rate in Hasan (2002) model renders its acceptability problematic in the context of Islamic finance. Moreover it can be shown that ultimately the return to the financier is equal to the interest rate and the risk premium. This makes the robustness of the model questionable” (PP. 47-48).

This is a naïve observation to put it mildly. The model under reference was presented first in Hasan (1985) article published in the King Abdulaziz University Journal. The later writings in 2002 and 2010 on the subject maintained the position on the ratio question. And no subsequent publications were noticed in English language at least by-passing the model. One can see its imprints on the writings of both Bacha (1997) and Habib (2002).

The 1985 paper discussed the determination of sharing ratios in the realistic scenario of Islamic banks operating in competition with interest charging conventional banks in a dual financial setting. The model postulated that the profit sharing ratio  $\sigma$  for the bank at the macro level is likely to be the function of four variables –  $r$  the expected rate of profit on total capital employed, the ratio  $\lambda$  of bank finance to total capital invested, the rate of interest  $i$ , and a risk premium  $\alpha$ . The message was that in a dual system interest rate will be an unavoidable influence operating on the profit sharing ratios. Illogic alone could go against this truth. In the competitive setting of financing religion cannot be assumed to influence customer choice. Will it be reasonable to presume a faith-neutral banker to opt for putting his money in a profit sharing project if the sharing ratio is not expected to yield a rate of return on his investment at least equal to the prevailing rate of interest plus the premium for risk his investment carries? Can we deny the fact that current Islamic finance is using interest rates as bench marks so brazenly?

The so-called innovative model the authors have put up in their paper is complicated, is based on unrealistic assumptions and stands on non-existent evidence. It does not spell out any *workable* policy conclusions. Computer simulations suit natural sciences which have eternal laws; social dynamism tends to throw their forecasts in economic matters fast into the dust bin of history.

Allah knows best

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