A Study on New REGULATIONS AND ISLAMIC BANKS

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This paper examines banking regulations in India briefly and then takes up the case of Islamic banks (non-banking financial companies) working in India. It undertakes a comparative analysis of Islamic banking and interest-based banking, discusses issues and constraints of Islamic banks, specifically in the Indian context. The paper goes on to make relevant recommendations and suggestions for the growth and stability of this nascent industry.

Financial system consisting of financial institutions, financial instruments and financial markets provide an effective payment and credit supply network and thereby assists in channeling of funds from the savers (surplus sector) to the investors (deficit sector) in the economy. The task of the financial institutions or financial intermediaries is to mobilise the savings and ensure efficient allocation of these savings to high yielding investment projects so that they are in a position to offer attractive returns to the savers. Non-banking financing companies which work on profit / loss basis also play an important role in mobilising savings and allocate them to productive uses. In this paper I have presented a few aspects of Islamic banking in India with special emphasis on Indian banking regulations. There are a number of other issues associated with Islamic banks, which cannot be overlooked. Since these banks will be facing several challenges and constraints in the modern financial system which is transforming itself into a global financial world, one has to give serious thought to this aspect also.

According to Islamic principles, interest on borrowing as well as on lending or deposit mobilisation is prohibited and the economic agents as a make investment in financial assets and participate in financing of real assets on profit and loss basis.There is a general apprehension about the applicability of profit and loss (interest free) banking in the economic system. The common question which is generally raised is as how the financial system can operate without interest? The savers in the economy need reward for parting their savings to deficit units in the economy. Accord-ing to classical school, interest rate represents the rate of exchange between present and future goods. The rate of interest signifies the price of a loan of present money in return for a promise to repay future money. Since the interest is the price of credit, the factors determining interest rate are rather naturally analysed in terms of demand and supply of loanable funds. This school of thought uses productivity and thrift and interest rate as corner stone of theory of finance. Interest rate does every thing to encourage savings and stimulate demand for savings. This concept is apparently not compatible with the philosophy of profit and loss based on supply of savings and demand for it.

Another equally important school founded by Keynes has shown some reservations for the above theory. Keynes insisted that savings and investment varied directly with the level of income and in turn they determine extent of aggregate demand and thereby level of income. Thus interest rate is not a factor in determining economic activity. It is the profit or loss which guides economic process. Even in a monetary framework in free market economy, interest rate is not determined by the banks or the lenders independently. They have to keep in mind demand for funds and supply of funds with them On the other hand expected rate of profit which can be made by the employment of capital and which is totally independent of the quantity or the

volume of the money influences the interest rate structure. (Recardo's Principles quoted in J.M.K. 7 (pg. 190). If the profit rate is expected to be lower in future then the existing lending rates, demands for funds decline and as a result banks have to adjust their lending rates downward depending on the credit rating of the borrowers. Thus it is the profit and loss and not the interest rate which determines the demand for finance and growth of investment and size and degree of other economic activities. Economists on Islamic financial system have argued that it is an error of modern theory to treat the entrepreneur and user of funds as the second rate citizen and rate financial institutions as the first class citizens working as locomotive for development and growth. There is a view that finance is not a capital, it is only potential capital and requires the service of the entrepreneur to transform it into real assets for actual productive use. The lender has nothing to do with the conversion of money into capital and with using it productively. The whole risk is thus bond by the user of finance. In such a system, resource mobilisation or creation of liabilities by the Islamic banks on the one hand and utilisation of these resources or financing of assets of other entities by Islamic banks on the other hand assumes importance. The bulk of liabilities of Islamic banks can be decomposed into current and investment deposits. The nominal valueof current deposits is guaranteed by the banks. In Malaysia, principle of Al Wadiah (trusteeship) is used for mobilisation of demand and saving deposits. These deposits do not receive any return as banks provide transaction facilities.

Investment deposits are accepted on the basis of Al Mudharabah (trustee profit sharing). In Malaysia, Pakistan and Iran profits are shared between the depositors and banks. In Pakistan, investment depositors get return on the basis of profits earned from the projects financed by their deposits. At the same time, the investment account holders or long term depositors (Malaysia) bear part of the losses if the investment made by the banks is not profitable. On the assets side, different principles are used for different kinds of financial facilities offered to customers. For project financing, the principles of Al Mudharabah or Musharakah (partnership or joint venture with profit sharing) are used. The former works in a manner used in the case of investment deposits. In this, bank provides the entire capital and the borrower, often an entrepreneur, provides the management services. The profit is shared accordingly to an agreed proportion while the loss is borne by the bank alone. Under the model of Musharakah, the bank shares the cost of project with the entrepreneur based on an agreed proportion basis and both parties have the right to participate in the management of the projects. The profit from the project is distributed according to an agreed ratio, which is not necessarily the same as the share in the cost. As the sharing of risk and loss is the fundamental principle in Islamic banking, model of banking system provides for accumulation by the banks for loss compensating balances during the phases of high profits as well as for deposit insurance, asset diversification and monitoring of project to reduce the risk borne by the investment depositors (long term depositors).

Banking Regulations in India

Now I turn to banking regulations in India briefly and then take up the case of Islamic banks (non-banking financial companies) working in the country. Indian banks are governed under the Banking Regulation Act 1949, Reserve Bank of India Act 1934, Negotiating Instruments Act and Co-Operative Society Act. Banking regulations provide working framework for banking companies, which accept deposits from public for lending or investment. The deposits are with drawable on demand or after a fixed maturity period. Banks' provide cheque facility, drafts etc. and generates deposits through deposit multiplier. Thus they create money supply and add to

monetary liabilities in the system. Indian banks have been subjected to a number of banking regulations and guidelines as prescribed by the RBI .Banks in India have to maintain cash reserves ratio (8.5 per cent at present) of which 3 per cent does not get interest and remaining 5.5 per cent get interest at the rate of 4 per cent per annum. Statutory Liquidity Ratio (SLR) is another important condition to be met by the banks.

Liquidity assets comprise investment by the banks in central government securities and other approved securities, which earn market determined interest. The Central Bank uses CRR and SLR as instruments of monetary control. The RBI has used CRR frequently to control the monetary liquidity in the economy. The Central Bank has used Bank Rate to encourage or discourage bank credit. demand in the economy. The above instruments cannot be used for Islamic banks as they do not function on the basis of interest. Other sets of conditions which banks have to meet are capital adequacy, assets classification, provisioning for bad debts and income recognition norms. Minimum capital base for a bank is Rs.200 which will get raised to Rs.300 crore and further to Rs.500 crore. The issue No.1 which is a permanent eye sore for Islamic banks operating in the countries with interest based banking is that they cannot function as banks unless powers of issuing cheques are given to them. They cannot be members of settlement / clearing house unless they accept two conditions regarding their liabilities and assets like conventional banks who have to keep fractional cash reserve with the Central Bank and statutory liquid assets in their assets. Thus banks in India have to maintain deposit account with the Central Bank over which they get interest. The SLR includes Government and approved securities.

A bank licensed by the RBI becomes the part of monetary system, which means it can create money by deposit generation through deposit acceptance. Since these assets are interest based, Islamic bank cannot hold them. Consequently, the Central Bank cannot act as the lender of last resort because such accommodation by the monetary authority is also interest based. Islamic banks cannot inter-act with conventional banks based on principles of interest. A silver lining which is emerging today is that banks are being subjected to prudential norms, cash reserve ratio and statutory liquidity ratio How-ever, statutory liquidity ratio and cash reserve ratio have been reduced. Interest rate have been decontrolled. Interest on cash reserves have been substantially reduced.

Islamic Banks (Non-Banking Financing Companies) in India and RBI Regulations

Islamic Banks (Non-Banking Financing Companies) in India and RBI Regulations Islamic banks in India do not function under banking regulations. They are licenced under Non Banking Finance Companies Reserve Bank Directives 1997 RBI (Amendment) Act 1997, and operates on profit and loss based on Islamic principles. RBI has introduced compulsory registration system.

Only those NBFCs which have net owned funds equivalent to Rs.50 lakhs and above can be registered with the RBI with the minimum capital of Rs.25 lakhs. Subsequently, in the Monetary and Credit Policy for the year 1999-2000, it was proposed that in respect of new NBFCs, which seek registration with the Reserve Bank and commence the business on or after April 21, 1999,

the requirement of minimum level of net owned funds(NOF) will be Rs.2 crore. The RBI (Amendment) Act, 1997 has been the most recent effort to address the issue of laying down a comprehensive framework for regulating the NBFCs. Exercising the powers derived under the amended Act, a set of regulatory and supervisory measures was announced by the Reserve Bank in January 1998. The broad thrust of the new Act has been to provide a greater degree of comfort and safety to depositors, while, at the same time, fostering the development of a healthy and diversified financial sector. Accordingly, entry-level norms for new and existing NBFCs have been laid down. Among the various measures introduced are compulsory registration of NBFCs engaged in financial intermediation, prescription of minimum level of (NOF), maintenance of certain percentage of liquid assets as percent of public deposits in government bonds, creation of reserve fund and transfer thereto every year a certain percentage of profits to reserve fund.

The regulations also provide for measures like credit rating for deposits, capital adequacy, income recognition, asset classification, compulsory credit rating provision for bad and doubtful debts, exposure norms and other measures to keep a check on their financial solvency and financial reporting. While the regulatory framework has been dovetailed primarily towards NBFCs accepting / holding public deposits, the supervisory mechanism for NBFCs is based on three criteria viz. (a) the size of the NBFC, (b) the type of activity performed, and (c) the acceptance or otherwise of public deposits. Towards this end, a four-pronged supervisory setup consisting of on-site inspection, off-site surveillance, exception reporting by NBFCs' statutory auditors and market intelligence system has been instituted. The NBFCs have also been directed to constitute audit committee, consisting of not less than their members of their Board of Directors, if the deposits exceed Rs.50 crore. They have been required to follow a uniform accounting In so far as accepting public deposits is concerned, NBFCs are akin to banks, except that NBFCs cannot accept deposits payable on demand. But it needs to be recognised that as public deposits are unsecured, the accepted global practice is that only banks which are regulated and supervised should be the main institutions that could be permitted to seek public deposits. It is against this background, public deposit taking activities of NBFCs are regulated in the same manner as banks. This is the underlying element of the regulatory regime presently being put in place in respect of NBFCs in India.

There are several Baitul Mals working in cities as well as in villages. Only 10 to 15 Islamic banks with deposits of about Rs. 75 crore operating all over the country in various states. They are actually Non-Banking Finance Companies which work on profits/ loss basis. Islamic banks by and large cater to the needs of local area except a few of them operating across districts or states. Their sources of funds are limited and as a result these banks have to operate on small scale missing the economies of scale.

Islamic banks in India provide housing loan, on the basis of co-ownership, venture finance on Mudarabha basis as well as on Musharaka basis and consumers loans. Some banks finance transports also on the mark up basis via hire purchase. Education finance and skill development finance is also provided by them. Investments are made in government securities, small savings schemes or units of mutual funds. Investment in shares of companies is also made by some Islamic banks. Hire purchase and lease finance are other source of investment. Islamic banks as referred to in the preceding paragraph face resource constraints and have narrow financing avenues. Their capital base is small and weak. In order to overcome these problems they can

diversify into equity based financing and resource raising can be done through issue of equity shares.

Islamic banks in India can offer their assets portfolios of primary securities in the form of open ended mutual funds units / shares for sale to investors. Islamic banks can be identical to open ended mutual funds that hold only traded non-interest bearing assets. The shares / units of these banks can be used as a transaction medium because investors can withdraw / transfer / sell such units / shares. The units can be listed on the stock exchange also and their value can be ascertained in the market. It is perhaps worth emphasizing that for Islamic banks, resource mobilisation and investment through units or equity, need well functioning equity exchanges market without any tax or penalty on frequent trading. An important development in Indian financial market is the emerging and widening strong capital market with a broad based regulatory system in favour of investors. Now Islamic banks can use two way route they can mobilise capital resources by issuing equity shares and can invest in equities of corporates and financial institutions. The setting up of mutual funds is another important route. Islamic banks can float mutual funds schemes offering dividend on units and these funds can be invested in corporate shares.

However, Islamic banks functioning on profit-loss basis have developed knowingly or unknowingly a number of deficiencies. First, they have not developed adequate internal control system, as a result their accounting system is not very transparent. You may be aware that transparency is the directive of Islam. A number of times they are not able to follow the directives of regulatory authorities pertaining to deposit acceptance from public. For instance, they hardly go for credit rating. They are not submitting required information and data to Reserve Bank of India. Their monitoring system warrants appointment of technical people familiar with reporting system. It is also observed that accounting practices needs to be learned by the officials of these banks Lack of skilled staff, professionals and infrastructure frustrate their effort to expand and enlarge their operations.

There has been very little effort to provide training facilities. However, there is good news that government would be permitting NBFCs to accept foreign share holdings even on foreign partnership basis upto 100 per cent. This relaxation will enable Islamic banks to augment their resources through foreign holding by foreign investors, consolidate and formalise their operations. Foreign partners bring with them improved standard of disclosures and better management practices.

Comparative Analysis of Islamic Banking and Interest based Banking

There are several benefits of equity based or profit / loss based Islamic banks. The virtues of equity based
banks are more obvious, when we compare them with conventional interest based banks. The conventional banks are prone to runs, such runs may bring commerce to halt when the banks' deposits are the main transaction medium. As bulk of their liabilities are fixed in nominal value and are payable on demand, when bank's assets which are not liquid or tradable, fall in value due to bad debts or non performing assets, all the deposits of banks cannot be repaid. Even rumours are enough to liquidate the banks. To summarise, banks' assets are illliquid and deposit liabilities are fixed in value and can be withdrawn / converted into other assets of equal value at will. If the

run on deposits is high, the banks need lender of last resort to ensure continued refinance facility. Such help encourages banks to undertake risky ventures and builds up inflation in the economy. As regards Islamic banks with equity based resources and assets, need not fear of run on them because holdings of units /shares can be en-cashed in the market. Here I have made a strong assumption that Islamic banks can develop their own efficient exchange market.

In Islamic financial system, return to banks liabilities is a direct function of the return to their assets as several assets are created as partnership contracts. The banks can sell their assets or partnership contracts. Since the securities markets are becoming efficient and safe, and disclosure norms, monitoring of banks or firms issuing equity, margins on trading, investors protection norms, settlement procedures, improved credibility of documents and settlements are being introduced, the equity investment in corporates has become safe. Islamic banks can invest in corporate equities. Now firms have to improve their performance in order to be successful in mobilization of resources through issue of equity. This is not in the case of interest based lending without improving their financing, the entrepreneurs can borrow huge amounts and divert them to undesirable activities. Interest based banks suffer from adverse selection weakness.

There can be one danger for Islamic banks based on equity resources / investments or listed equity investment that equity prices may fluctuate. In the phases of rise in equity prices, there may not be any problem but during the phase of down turn, the Islamic banks may face fall in the value investment. These banks will have to adopt the technique of “Mark to Market”. They may also set up “Risk Funds” to compensate fall in net worth. The investment of resources by Islamic banks also can get investors protection environment. A firm issuing equity should undergo full appraisal of its performance and program me and has to obtain credit rating from a credit rating agency before coming in the market. Islamic banks can invest their resources in these equities. In a way equity based financing can improve debit equity ratio of companies. Moreover, equity based financing has been considered superior to interest based financing. Besides the institutional advantage of Islamic banking and financial system as analyzed above, there are social virtues, which occur to the society.

First we can take deficit financing of Government. Government borrows from the market as well as from Central Bank of the country. These borrowings are done without having any relation with the level assets to be created. As such they are inflationary and unproductive, whereas in Islamic system, Government cannot borrow without having partnership of the lender in the assets or projects being financed with the respective borrowings. As Islamic system would encourage capital formation by the Government at a higher rate than the interest based borrowings by the Government, there would be a direct benefit to the society through higher investment, higher growth and more employment. Since Islamic financing is based on partnership, one has to dispose off the goods or inventories financed, no one can accumulate the inventories beyond the contract - period with the financing banks.

Islamic banking can eliminate unaccountable economic activities, as every economic activity has to be financed through legal contract and physical verification of real assets under contract. There is no room for diversion of funds. The profit / loss sharing principle encourage fair distribution of profit and loss. Since interest free banking is anti-inflationary, it would encourage growth of real income and domestic savings. Interest based banking has produced outflow of

capital from developing countries particularly from African countries. The interest outflows sometime have eaten the entire foreign exchange earnings or networth of countries indebted.

Government borrowings also lead to high interest liabilities, which have to be paid by taxing the people. It is common knowledge that when Government is run by politicians, they have tendency to resort to large borrowings and spent the same unproductively with no additional real capacity creation in the economy. There are losses and losses to be financed by further borrowings. This has resulted in deprivation of private sector from financial resources. Government borrowings can be project based by promoting joint ventures between Government and Islamic banks. Islamic banks can participate in India on "Build, own, operate and transfer" basis.

Issues and Constraints of Islamic Banks

As regards partnership by Islamic banks in a firm, the bank has to make sure that the manager does not shirk his responsibilities or obtain other non-pecuniary benefits at the expense of non-participating partners and (2) ensure the veracity of the profit statements. This type of monitoring of facts and data on firms in which Islamic bank invests, could be expensive. Islamic banks, however, need to set up monitoring cell to keep them informed of the internal function of their joint venture, which they are financing through partnership. The implication is that banks and entrepreneur have to function very closely. For long term investment, Islamic banks should take position only after the technical, economic and financial viability, has been examined and appraised. A professionally equipped Islamic bank needs to invest in assets providing a return in excess of the cost of the funds tied up and for this purpose it is important to ascertain the cost of capital which is equivalent to the required rate of return below which a company may not undertake investment without prejudicing its present networth and the wealth of its owners or equity shareholders. A second issue which is just on the horizon is the scale of operations of Islamic banks. The globalisation of financial markets would warrant merger of small banks to bring into shape a big bank with modern banking infrastructure. Islamic banks being small in size, can merge together to make a large bank. The induction of trained and professional staff would be a No.1 necessity. Islamic banks working today have to examine whether they have standardised their functioning. Have they introduced corporate concept with transparent accounting standards ? Islamic banks in India can invent new types of assets like Malaysian Islamic banks.

Diversification of their assets and innovation of new assets can help them to expand their clients. For instance along with equity and units they can think of investing in derivatives. If so, they would need professionals. They can provide merchandise banking and other financial services. In Malaysia Islamic banks provide insurance services. A highly wanted assurance for the growth of Islamic banking is the establishment of training institutions in the countries where they are working. The imparting professional training is costly. In India at least they can pool funds to set up training institutions.

The last but not the least, particularly in India, Islamic banking has been constantly in short term and medium term operations though some of them are undertaking long-term finance also. It is understood that inability to evaluate projects profitability has tended to act against investment financing. Some borrowers frustrate the banks appraisal efforts as they are not reluctant to provide full disclosures of their business. Moreover, the borrowers do not observe business

ethics which make it difficult to establish close bank-clientele relationship - a condition for successful Islamic banking. As a result a number of Islamic banks have been closed during the recent years. Adverse selection has been one of the reasons for their closures.

Recommendations and Suggestions

1. Islamic banks should implement prudential norms in order to strengthen their quality of functioning and capital adequacy and asset up gradation should receive focused attention.

2. They should mobilize resources on the basis of "Mutual Funds" model and investment should be equity based and partnership - contract based. They should promote inter-Islamic banks trading in "Contracts". If Islamic banks can make offer to public through capital issues and get listed on stock exchanges then capital would become marketable and liquid. Inter-bank lending can be set up on the profit sharing basis.

3. They should diversify instruments of investment on the lines done in some of the countries.

4. Islamic banks should set up "Risk-Funds" to compensate their shareholders or depositors during the period of losses. They can declare special dividend.

5. They have to enlarge their scale of operation through mergers and should modernize themselves to compete with other institutions.

6. They should set up training institutions on Islamic banking and should impart training to borrowers and other public to increase their clientele.

7. They should earmark some funds to finance poor people and should provide them job training so that they can create employment for themselves. Such experiments are already being done in Tamil Nadu by English Missionaries. But assisting poor people is not the only objective, this is one of the objectives.

PROFIT AND LOSS SHARING RATIOS A HOLISTIC APPROACH TO CORPORATE FINANCE

This paper considers the possibility of a holistic approach to designing the capital structure for new companies through the use of profit and loss sharing ratios alone. The scheme is presented in bare essentials stripping any details of agency theory and economic arguments that may be cited in support. The objective is to invite criticism from fiqhi as well as other

perspectives so that the potential for abandoning or further refinement of the proposal can be considered.

Introduction

Based on justice / welfare implications, Islam approves certain forms of financial contracting and prohibits others. Amongst the prevailing forms, profit and loss sharing arrangements on the pattern of equity contracts come closest to the Islamic ethos whilst pre determined fixed interest debt is considered as unjust and a taboo. Apart from profit and loss sharing arrangements, there is also a spectrum of other instruments that resonate with the spirit of shari'a and could cater for a variety of investor risk preferences and entrepreneur financing requirements. However, a need is always felt to synthesize more instruments to broaden and deepen financial intermediation and investment prospects. Below, a broad concept is floated to examine if the capital structure of a new corporate entity can be designed purely on the basis of profit and loss sharing ratios. Borrowing from the modern theory of corporate finance, the scheme makes use of residual rights, bankruptcy threat, signaling, and dilution prospects to expect that economic efficiency will obtain. Shari'a compatibility is expected to be achieved through making the bargaining process, as far as possible, linked with differential rights in residual assets. However, details of building supporting arguments are deferred until such time that a broad feedback as to the shari'a compatibility of the basic proposal is obtained.

System Constraints

The macroeconomic management that exists today is a far cry from the environment of some 1500 years ago when Islam was vouchsafed through the Prophet Muhammad (peace be upon him). To the Prophet, fluctuations in commodity prices were the result of natural processes and it was inappropriate for government to intervene (to fix prices) as it inevitably involved injustice. In parallel, any deliberate steps that were undertaken by market participants to obviate the free flow of demand and supply signals (such as hoarding) were condemned from an ethical perspective. Central monetary and fiscal arrangements were non-existent in the sense that we know of today. Thus, the present environment wherein fiscal, monetary, and legal infrastructure bears extensively on market processes hardly provides a semblance to the early days of Islam.
Consider the role of money and credit in the modern economy. Unraveling its impact on prices and output has attracted some of the finest brains for the past some two and a half centuries but the debate is still on. The conclusion at this stage is that monetary processes have a good deal of impact on prices in the long run but perhaps imprecise impact on output except in extreme cases. Whilst one wonders if a prophet was amongst us what he had to say on this aspect of government intervention in the economy that affects prices, the fact remains that decisions have to be made and for Muslims as far as possible, in accordance with the precepts of Islam. One corollary that may be drawn from the above discussion is that based on Islamic justice, holders of idle money balances (savers) are not entitled to any compensation for inflation that results from natural processes (interactions of technology, productivity, population growth, and environmental factors such as weather etc). However, a question may be raised if justice is compromised by not compensating them to the extent the level of rise in general prices is induced by money expansion? Leaving this question for experts in economics and shari'a to resolve, professionals in finance can speculate at least one implication. Within the prevailing economic management mechanisms, investors, in particular those with conservative risk preferences, will expect to be compensated for that portion of depreciation in their purchasing power that owes to money expansion. Given lags in monetary phenomenon and their impact on general price level, as

well as complexity involved in separating inflation due to monetary processes from that due to natural processes, some kind of proxy expectation has to be figured out.

Some may like to call the above mentioned proxy or minimal required rate as risk-free rate; others a back door way of introducing fixed rate obligations within Islamic finance. The latter argument is contested on two grounds. First, what is being discussed here is 'expectation' not 'entitlement'. Expectations are a natural result of the broader system parameters that influence human behavior. Given that the prevailing monetary, fiscal, legal, tax, and supervisory regimes take interest based structure for granted, rather encourage and support such arrangements through various incentives (for example, interest is expensed), if one were to work within the system, focus on a benchmark expectation is natural. Second, focus on 'expectation' is not a 'justification' for entitlement. From the perspective of Islamic justice, many interim steps would need to be argued to tread on that path. In particular if money induced price changes affect on the one hand, all goods and asset prices and on the other hand all sections of the society proportionately in the same way, why should idle money balance holders alone out of all other classes of asset holders be entitled to a 'risk-free' rate without participating in the risks of the productive processes that generate return. After all, investors in all other asset classes bear the risk that the return on their investments could fall below an assumed risk free rate or even below zero. This boils down back to the argument that 'entitlement' to return as distinct from 'expectation' has to be earned through sharing in the risks of a project, insofar as Islam is concerned, even within fiduciary money economy.

Coming back to the importance of expectations about a benchmark rate in the present system, it is proposed that the net impact of natural processes of diffusion of technology, productivity enhancement, and population growth is expected to spread over comparatively longer time cycles than of monetary policy. The rationale employed here is that some of the long-term factors mentioned before work against each other (automatic stabilizers). An argument can be made that monetary policy is in reality focused on these natural factors.

However, practitioners in finance observe extended periods of 'irrational exuberance' of asset price bubbles followed by recessions. In particular, there is usually a significant wedge between goods price inflation and asset price inflation due to some credit being diverted for pure speculation in securities markets. Thus, the claim that natural processes that may affect intrinsic demand for money work over longer cycles than monetary policy cycles stands. The implications are that insofar as investors, focus shifts from natural trends that are inseparable from our living and being toward artificial trends created by monetary policy. From the above intuitions derived from general observation, one implication for security design could be that in an economy where prices reflect only the interaction of natural processes that are spread over longer term time horizon, investor 'expectations' are formed differently than in an economy wherein the prime focus of investors is on implications for asset prices of day to day actions of monetary authorities. In particular, it may be argued that in the case of the former, benchmark yield curve may be expected to be pretty flat over different maturity buckets up to medium term horizons whilst in the case of the latter a rising yield curve under ordinary circumstances will be a norm reflecting increasing uncertainty over time on money induced changes in prices. This argument receives sympathy from the fact that repeated surveys of professional economic forecasters indicate failure to forecast interest rates and prices with accuracy beyond one year time horizons.

A stricter interpretation of the Islamic prohibition of usury in light of the pre-Islamic Christian practice would entail prohibition of linking return with time. As argued previously, this would be possible only if money induced changes in prices could somehow be immunized and changes in prices reflect natural processes alone. In this case, strong link between return and maturity spectrum could presumably weaken. Within the ambit of the present system, a disregard for demand of different return over different time horizons is inherently incompatible with the way return expectations are formed. In case of financing through profit and loss sharing mechanisms, 'offering' different rates for different time horizons in a manner fixed income securities obtain it, is incompatible with the Islamic ethos. To summaries, the proposal presented below is based on the following premises: -

- The prevalent economic system focuses investor's return expectations in relation to fixed interest benchmark rates for different maturity government debt or inter-bank lending and borrowing rates.
- Profit and Loss sharing vehicles offer limited potential for segregation into different risk-return parcelsgiven the same asset pool / going concern underlying all parcels. Also resolution of agency issues is costly that makes debt optimal vis a vis equity under some circumstances

Problem Formulation & Proposal

Can a method be designed to segregate equity into parcels / tranches of different risk-return profiles in an Islamically acceptable way given the constraints mentioned in the previous section? A simple way could be to issue different tranches of equity parcels A,B,C that provide different levels of residual control (tied to certain stipulated events) on company assets. Thus, tranche A provides control on plant and equipment, whilst tranche B on land, buildings and stock, and tranche C is like ordinary shares providing a residual control in general on company assets. Given such arrangement changes the risk of different tranches it provides a way to attach different sharing ratios and controlling rights on each parcel suiting different investors.

1. If the idea is shari'a compatible, then let tranche A promise 25% share in company earnings, tranche B 35%, and tranche C 40%. Say the estimated rate of return for the whole company is 30% pa. This means holders of A are expecting 7.5% pa and C 10% pa return.

2.Let us now introduce slight complexity. Let us suppose one year murabaha / JIBOR (whatever) yields 6%, 2 year 6.5%, and 3 year 7%. If we are targeting investors with 2-year investment horizon, we may adopt tranche A to their needs.

3.A sharing ratio of 25% pa defines ceiling on return on tranche A. Expected return on this tranche is 7.5%. A concept of targeted (expected not guaranteed) rate of return may be introduced here (say 7%) which is the indicative rate of return that the company management is targeting to deliver on parcel A.

Again, parcel A gives holders right to share in profit and loss at a ratio of 25% for two years with residual rights of ownership on specific assets in case its holders do not agree with the valuation (as a going concern of the company) on the basis of which their stake (in principal / face value) of shares is redeemed at stipulated maturity and providing further that such disagreement can be

triggered only if the then valuation entitles them below par. Note that the target rate is the rate announced and advertised as an objective to be pursued but not a commitment.

In the above arrangement, residual right of different classes of shareholders on different assets of the company can be combined with different control rights by agreeing upon assuming, diluting, or relinquishing full rights as that of ordinary shareholders depending on states of nature linked to redemption at the end of the stipulated period. Thus, if a targeted two-year share A facility cannot be redeemed at par at stipulated maturity, this gives rights to its holders to assume fully-fledged control rights like ordinary shareholders. This threatens ordinary share holders a dilution in control, an incentive to redeem A at par. An associated possibility is giving shareholders A the right to seek bankruptcy on 'disagreement' and avail title on pre-specified assets in case there shares are not redeemed at par. Thus, one choice triggers dilution, other bankruptcy, putting pressure on holders of C to remain 'honest' and make economically efficient decisions.
If holders of C value combined economic benefit of control plus residual net worth more than the alternative possibilities (dilution or bankruptcy) they will be willing to redeem / refinance A. In a religious sense, C are purchasing residual right on specific assets from A at a given price. One expects a mutually beneficial bargain between A and C and face value redemption under ordinary circumstances although below par redemption is not ruled out contingent upon company performance and prospects.

Legally acceptable bankruptcy triggers described above need to be refined further and tied to different contingent events to facilitate balanced and efficient resolution of conflict between Class A and Class C shareholders through bargaining. Redemption, of course, is not the only possibility. For a well managed company, refinancing is always an alternative. In this context, an option can be granted to class A share holders to elect at the end of two years, for redemption or re-financing on same or different terms. Call option for company management to redeem class A or class B at a given price after a certain stated period (anticipating better cashflows or re financing possibilities etc.) may also be included.

1. In the above arrangements, from a religious perspective, returns are expressed in terms of sharing ratios and realized returns are tied to the actual; at redemption a genuine buying and selling of valid property rights is occurring at mutually acceptable prices.
2. All income will flow first into a trust and distributed from there. As an option, trustees (may or may not) have the right to accumulate the (voluntarily agreed (hiba)) cut between the targeted and the ceiling rates on various tranches to smooth out flows. There is re-investment risk but company may / may not have the priority right to re-invest within, depending on its product portfolio life cycle.
3. In an economic sense, return offered has a direct connection and link with that realized through ceiling determined by the PLS ratio. The incentive structure is so designed that if company as a going concern offers actual rates way below targeted on shorter term class A shares, it will face higher re-financing rates in future (an issue of credibility). Investors get security because of residual right on certain assets that will be triggered if the company goes bankrupt (or company as a going concern is unable to pay face value on pre-stated maturity).
4. Variations of the above scheme are possible. A United States CMO (Collateralized Mortgage Obligation) like offshoot is possible for securitizing housing loans issued in an Islamic manner. Given cash flows and rates are more or less certain, even though

contractual obligations are different, US mortgage models can be adapted extensively. This can be done by securing a voluntary agreement from A that if return over projected horizon of 2 year crosses say 6.5% pa, the balance will be applied to redeem the face value of shares A on issue. An agreement can also be secured from tranche B holders (say expected horizon 5 years) and tranche C holders (say ultimate stake holders) that if the annual rate matches certain pre-defined targeted rate within that year, they will voluntary pass the surplus (trustee to smooth out flows) to redeem class A shares. For housing loan securitization, all pre- and repayments of principal can be applied first to redeem tranche A, then B, then C. Once Class A are redeemed, Class B can be redeemed similarly. Such securitization will help broaden and deepen investment and financing possibilities.

5. Given appropriate design, short-term (6 months to a year) company CDs may be possible based on PLS right (for a particular period) and linked to assets marked for this purpose (control contingent on non-payment of face at redemption).
6. If assessed as shari'a compatible, there is a potential to integrate the concept into a 'holistic approach to capital structure' in a shari'a compatible manner. Of course, a way has to be find out to bridge prevailing financing patterns with the proposed. But that is to explore potential rather than the 'shari'a compatibility. At the concept stage, it is the latter that is more important.

Notes:

There is an alternative possibility (no judgments implied here) that repetitive execution of monetary transmission mechanism through existing institutions and security instruments affects different sections of the society differently. In particular, there is need to examine if the reviling infrastructure increases the gap between 'haves' and 'have not's given differential capacities of two groups (if not willingness) to 'leverage' and 'de-leverage' at different stages of the monetary cycle. Also, the two groups hold different asset classes and the prevailing monetary methods may be benefiting some vis a vis other. These issues need to be taken into account to provide a comprehensive Islamic perspective on the issue. A famous phrase floated by Dr Alan Greenspan, Chairman of the US Federal Reserve Board, some years back.