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Methods of profit sharing in Interest-Free Banking: identifying areas of concern

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Abstract: It is essential that interest-free banks strive to move away from the currently adopted capital / period based calculation mechanism for determining its own profit share, to an objective method aimed at determining the profit sharing ratio in the participatory venture as a whole. Ideally, a profit sharing ratio could be fixed for an individual venture considering relevant aspects that are of importance to each partner, based on independent negotiation. This would result in a fair share of the profit accruing to the bank, in proportion, at least partially, to the amount of funds invested and any expertise extended, while the client, too, secures a fair return for his input in the form of capital or labour. Although there could be no bar to using the rate of return / period method for purposes of analysis and comparison, adopting it as the very basis of profit share calculation does not seem to be reflective of the spirit of equity participation.
Keywords: interest-free, banking, financing, profit, sharing, equity, investment, joint-venture.

Introduction

A properly formulated scheme for profit and loss sharing in joint enterprises is expected to achieve a just distribution of gain and liability among the participants. Taking the ideals and guidelines put forward for the implementation of ethical interest-free participatory financing especially by the religion of Islam and the prevailing conditions into consideration, this paper examines the acceptability of the process generally adopted by interest-free banks for determining the profit sharing ratio in projects financed on joint equity basis. The discussion is mainly relevant to adopting the equity basis in financing ventures where the capital is jointly funded by both the financial institution and the client. Thus, the process of determining the profit sharing ratio analysed in the paper is not directly relevant to the ratio adopted for division of profits between the depositors of the institution and the share holders. The current paper attempts to identify the influence of interest based financing that is predominent in the current banking scenario on the operation of the profit sharing mechanism of interest free banks, by analysing the method employed by the latter for determining the profit sharing ratio.

The mechanism for determining the profit sharing ratio in joint ventures

Instead of a stipulating a return based on the capital extended as practised by conventional banks, in participatory financing of ventures, interest-free banks are required to agree on a profit sharing ratio so as to comply with Islamic ethical guidelines. Equity financing of single transactions that are short term in nature involve single exports and imports, financing of produced goods etc, while financing of projects involving production and manufacture could extend over longer terms. In determining the profit sharing ratio in such ventures the bank primarily takes into account the envisaged rate of return on capital, also considering factors such as the size of the investment and the period of exposure, i.e. the duration taken for realisation of profits or alternatively, liquidation. Usually, ancillary factors such as the nature of risks involved, additional business income that could be generated through other means from the same client and his credit record, too, are kept in view. It is pertinent to examine the method through which interest-free banks determine the profit sharing ratio in such equity ventures.

Determination of the profit sharing ratio in joint enterprises is done by interest-free banks through multiplying the amount of capital sought to be invested by the bank by the appropriate rate of return and by the expected period, arriving at the net return the bank wishes to realise through the venture. Thus, it is based on ascertaining the amount of return it intends to realise on its capital exposure. The rate could be marginally altered in view of the other factors referred to above, especially in the case of larger exposures, based on negotiation. In the case of smaller exposures, more often than not, the role played by negotiation happens to be minimal. Thereafter, the envisaged return thus calculated is divided by the expected total profit projected for the venture for obtaining the ratio of the bank's share in the profits. This means that the return sought by the bank is compared with the total profit the venture is expected to yield, and is then reflected as a proportion of it. After the bank has determined the amount of return it wishes to achieve, the remainder of the expected profit, irrespective of its size, is taken as the profit share of the client / joint partner, and the proportion of one to the other is held as the ratio of profit sharing. Since this method fundamentally aims at the bank achieving a predetermined return on the capital invested in the equity venture, it is necessary to scrutinize the level of its appropriateness Islamically in joint ventures based on mutual sharing and joint participation.

A venture expected to take a longer term for completion would invariably involve a higher share of profit being allocated to the bank. This is because the period of exposure, usually counted in months, is taken as the most important variable in the determination of the bank's profit share. Consequently, The other component, i.e. the rate of return, could alter marginally based on the other factors mentioned above. Owing to this state of affairs, it is seen that any negotiation with the potential partner on the bank's capital infusion almost exclusively centres on the monthly rate to be applied, along similar lines as when a conventional banking facility is applied for. The rate of return applied to different types of equity investments is almost always parallel to the corresponding lending rates for similar facilities in conventional banks, and no substantial change is observed to occur in view of the profitability of a venture. This scenario is largely attributed to the competition offered by conventional banks, whose presence has a curtailing effect on profit rates that could be demanded by interest-free banks. It is feared that potential equity partners would prefer loan capital at relatively low rates of fixed interest to risk capital with a higher demand on potential profits. Thus the interest rate on loan capital extended by conventional banks is taken as the primary basis for determining the rate of return on the risk capital invested in equity ventures, and more often than not, the liability borne by the bank through investing based on a profit and loss sharing platform is not given sufficient room to play an effective role in this process.

The bank succeeds in achieving the return on its capital as dictated by the rate applied, at the conclusion of the project, as expected. Any additional amount of profit over and above the sum projected initially could only result if the venture succeeds in realising a higher profit than was anticipated. In this event, by virtue of the share of the bank being fixed as a ratio of the total profit and not as a lump sum or a percentage of the initial capital outlay, the bank would be entitled to a higher return, irrespective of the amount. However, it should be noted that the possibility of earning such a higher return is minimal due to banks entertaining only ventures that lead to a definite return, and incorporation of additional clauses that make the client entitled to any profit earned over and above a stipulated ceiling.

Some aspects of concern

It is evident that the rate of return on capital is taken as the basis for the calculation of the profit ratio in general, where the period of the exposure acts as the major variable. The process of determining the profit sharing ratio in joint ventures financed by interest-free banks, therefore, starts from the amount of capital invested by the bank in the venture. Consequently, the process is largely similar to fixing a margin of profit in trading products offered by interest-free banks such as leasing and mark-up sale. Reflection of the return sought by the bank as a percentage of the capital ceases only at the final stage of concluding the participatory financing contract, at which point the amount is converted into a percentage of the total profit expected and recorded as such in the agreement, principally for the purpose of Islamic ethical guidelines compliance.

An adverse effect of employing this method in equity ventures is that the profitability of the venture is prevented from playing an adequate role in determining the profit sharing ratio. It is observed that due to adopting a mechanism designed to achieve a defined return, the profit share accruing through a venture yielding high profits is not significantly different from that achieved through one that is lower in profits. Therefore, the profitability of the venture would not necessarily bring about a higher return to the bank, usually the major provider of capital, and through it, to the bank's investors, as the profit share is determined on the basis of a specific amount of profit the bank desires to generate through the project. This in turn restricts to a large extent a primary role interest-free banks are envisaged to play, viz. facilitating an equitable distribution of wealth among entrepreneurs and principal owners of funds. Consequently, the investors of the bank are generally observed to receive a flat return that does not adequately reward them for the risk capital they had provided, even when the projects funded through their monies realise huge profits. Fundamentally, this could reflect the anomaly arising out of juxtaposing a capital-centred rate of return method within a profit-centred participatory framework.

Ideally, the expected period for the realisation of profits / liquidation should not play a role in determining the profit share of any single partner. However, in the method currently employed, the primary emphasis is placed on the time factor, which is conceived as the fundamental basis for multiplication of the return. Time, being a factor that affects the venture as a whole and consequently, the interests of both partners, should be regarded as a common element, and its impact on the profit sharing ratio overall should be zero. Thus, there appears no justification for the interest-free bank unilaterally adopting a profit share calculation mechanism that fundamentally depends on the element of period for fixing its own share of profit exclusively. A true implementation of equity financing could demand that the element of time be excluded from playing a role in fixing the profit share of one partner to the exclusion of the other.

The ethical principle with regard to distribution of profit both in participatory financing and investment is that the profit shares of partners should be fixed as a ratio of the total profit realisable through the venture. It is due to this reason that fixing a lump sum or a ratio related to the capital as the profit share of any partner has been ruled inadmissible. Fixing a ratio of the capital as the profit share too is essentially tantamount to fixing a lump sum, as the capital being definite and fixed, a share proportionate to it also is definite. In the process discussed above, the profit is primarily determined as a percentage of the capital for all intents and purposes, although converted into a share of the total profit at the time of concluding the contract. This latter measure is considered sufficient to ensure Islamic ethical validity of the contract apparently on the basis that, as long as a ratio is fixed for profit distribution between the partners without assigning a lump sum profit to any, the exact process through which the partners choose to determine the ratio is not of material relevance. However, it would be pertinent to examine the extent of the effect of such conversion on the reality of the transactions.

A fair number of enterprises that interest-free banks agree to finance on an equity sharing basis comprise ventures involving a near certain amount of profit (Sadique 2006). Possibly due to ingrained elements of extreme risk aversion inherited from the conventional culture of lending against fixed interest, interest-free banks are still not noted to be favourably inclined towards investment in open trade, where profits are not secured in one way or the other. Thus, although exceptions do exist in the form of equity-based project financing, a good proportion of equity based facilities extended currently involve ventures where the return is fairly secure, such as financing of exports against letters of credit, financing of manufacture against a confirmed order, financing of imports involving goods that have a ready-made market etc. In these instances, the margin of fluctuation in profitability is almost negligible, as the profits realisable could be projected to a near-certainty. Therefore, the primary purpose of fixing the profit share of each partner as a proportion of the total profit, viz. to allow variation of the profit share according to fluctuation in the profit levels actually realised, remains hypothetic to a great extent.

Conclusion

Based on the above, it could be said that conversion of the profit rate calculated initially as a lump sum return on the capital invested by the bank into a percentage of the net profit only serves the purpose of achieving Islamic ethical admissibility. Thus, the effect of fixing a profit ratio related to net profit thus could become apparent only in the unlikely event of an unforeseeable loss befalling the venture. As far as the reality is concerned, the investment is designed to achieve a fixed return as calculated based on the capital invested. Consequently, although a direct violation of the Islamic ethical guidelines is avoided through converting the expected return on capital to a proportion of the expected profit, the process could not be held to be indicative of intent at a genuine sharing of the profits.

Moreover, financing on the basis of participatory financing / investment does not result in the creation of any debt. Therefore, the appropriateness of employing this technique in fixing the profit sharing ratio relating to participatory financing / investment ventures, is open to question. Thus, in the context of interest-free banking, it seems unjustifiable that the mechanism adopted for the calculation of a fixed return in debt financing itself be employed in connection with equity financing, where the purpose is mutual sharing of an uncertain amount of profits to be realised.

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