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Lack of Profit Loss Sharing in  
Islamic Banking: Management  
and Control Imbalances

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An imbalance between management and control rights is attributed as a major cause of lack of Profit Loss Sharing (PLS) in the practice of Islamic finance. Given this dichotomy, the agency problem gets accentuated, which may put the PLS at a disadvantage vis-à-vis other modes of financing. However, there is no theoretical reason to believe that PLS is inherently inefficient. In certain circumstances, this in fact may serve some important economic function.

## 1. Introduction

Profit Loss Sharing (PLS) dominates the theoretical literature on Islamic finance<sup>1</sup>. Broadly, PLS is a contractual arrangement between two or more transacting parties, which allows them to pool their resources to invest in a project to share in profit and loss. Most Islamic economists contend that PLS based on two major modes of financing, namely *Mudaraba* and *Musharaka*, is desirable in an Islamic context wherein reward-sharing is related to risk-sharing between transacting parties<sup>2</sup>. Almost all theoretical models of Islamic banking are either based on *Mudaraba* or *Musharaka* or both, but to-date actual practice of Islamic banking is far from these models. Nearly all Islamic banks, investment companies, and investment funds offer trade and project finance on mark-up<sup>3</sup>, commissioned manufacturing, or on leasing bases. PLS features marginally in the practice of Islamic banking and finance.

Whatever is the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their business. Even specialised Islamic firms, like *Mudaraba Companies* (MCo's) in Pakistan, which are supposed to be functioning purely on a PLS basis, have a negligible proportion of their funds invested on a *Mudaraba* or *Musharaka* basis. According to the International Association of Islamic Banks, PLS covered less than 20 percent of investments made by Islamic banks world-wide (1996

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figures). Likewise, the Islamic Development Bank (IDB) has so far not used PLS in its financial business except in a few small projects<sup>4</sup>.

Different explanations exist for this lack of PLS:

*First*, PLS contracts are inherently vulnerable to agency problems as entrepreneurs have disincentives to put in effort and have incentives to report less profit as compared to the self-financing owner-manager. This argument is based on the idea that parties to a business transaction will shirk if they are compensated less than their marginal contribution in the production process, and as this happens in the case of PLS, the capitalists hesitate to invest on PLS basis. The argument further goes back to a different world-view of ownership under PLS as compared to the capitalistic world-view that allows only those who own certain crucial means of production to be legitimate residual claimants in the production process. The entrepreneurs claim on residual income (profit). Capitalists, on the other hand, put an emphasis on the productivity of capital and, hence, show reluctance to bear any losses incurred in production. The unwillingness to bear risk on the capitalists' part and the entrepreneurs' tendency to exclude others from sharing profits has resulted in a less favourable response to PLS from the financial and business community<sup>5</sup>.

*Second*, PLS contracts require well-defined property rights to function efficiently. As in most Muslim countries property rights are not properly defined or protected, PLS contracts are deemed to be less attractive or to fail if used.

*Third*, Islamic banks and investment companies have to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions, which are already established and hence more competitive.

*Fourth*, the restrictive role of shareholders (investors) in management and, hence, the dichotomous financial structure of PLS contracts make them non-participatory in nature, which allows a sleeping partnership. In this way, they are not sharing contracts in a true sense; the transacting parties share financial resources without participatory decision-

making (Choudhury, 1998). Practice of MCo's in Pakistan is a perfect example of such a non-participatory PLS. The Mudaraba certificates issued by MCo's do not give voting rights to certificate holders, and hence no annual general meeting is called<sup>6</sup>.

*Fifth*, equity financing is not feasible for funding short-term projects due to the ensuing high degree of risk (i.e., the time diversification effect of equity). This makes Islamic banks and other financial institutions rely on some other debt-like modes, especially mark-up to ensure a certain degree of liquidity<sup>7</sup>.

*Sixth*, unfair treatment in taxation is also considered to be a major obstacle in the use of PLS. While profit is taxed, interest is exempted on the grounds that it constitutes a cost item. This legal discrimination and its associated problem, tax evasion, make PLS less reliable as a tool for reward sharing. This argument is quite true in the case of growth of MCo's in Pakistan. The MCo's showed an impressive growth till 1992 when their tax-exempt status was withdrawn.

*Seventh*, secondary markets for trading in Islamic financial instruments, particularly Mudaraba and Musharaka, are non-existent. Consequently, they have so far failed to effectively mobilise financial resources.

This paper considers the influence of management and control on internal governance of Islamic banks and finance companies. To distinguish between management and control demands a study of influence of board structure on firm's performance. Mudaraba, a major Islamic mode of financing, provides limited control rights to shareholders, thus creating an imbalance in the governance structure of PLS as proposed in Islamic banking and finance. This is one of the prime reasons for lack of PLS on the assets side of Islamic banks. Thus a consistent and complimentary management and control system is essential for steady functioning of Islamic banking and finance. In this paper, we argue that this imbalance needs to be removed in order to increase market appeal of PLS. Venture capital financing as practised in USA, UK and other European countries is a modern example of Mudaraba. This Western version of Mudaraba is in essence commensurate with Islamic teachings and provides a balance between managers and financiers in terms of control of business decisions.

Another important argument here is that Islamic banks should play a role similar to that of institutional investors, i.e., buying significant blocks of stock, holding them for a long time, and actively monitoring management, sometimes referred to as ‘relationship investing’.

In the recent past, there have been a number of developments in the Western world, which have been initiated by a comprehensive rethinking of who should control which activities and who should earn the return and bear the risks associated with those activities<sup>8</sup>. However, the debate on current issues in Islamic banking by and large has excluded any discussion on management and control rights.

The next section briefly explains the organisational structure of an Islamic bank. Section 3 discusses management and control in some detail before we move on to propose an alternative organisational form for Islamic banks in sections 4 and 5.

## 2. What is an Islamic Bank?

Like conventional banks, an Islamic bank is an intermediary and trustee of other people’s money with the difference that it shares profit and loss with its depositors. This difference introduces an element of mutuality in Islamic banking, making its depositors as customers with *some* ownership rights in it. However, in practice most Islamic banks have an organisational set-up similar to their conventional counterparts. In this paper, we discuss Bank Muamalat (BM), the first Islamic bank in Indonesia, to give an example of how a typical Islamic bank is organised and how it operates in the market.

BM started its operation on May 1, 1992 as a private Islamic bank under close supervision of the government and the central bank, Bank Indonesia. The organisational structure of the bank is given in Figure 1.

The Board of Commissioners (BOCs) substitutes the traditional role of a BODs. However, decision-making is constrained by a Shariah Supervisory Board that sanctions or rejects any proposals in the light of Islamic law. This supervisory board comprises eminent religious scholars who, although appointed by BOCs, are independent and have authority to reject any proposals deemed to be against the Islamic law. Management of business

operations rests in the hands of a Board of Directors (BODs)<sup>9</sup>, headed by a President Director who is directly responsible to BOCs, the Shariah Supervisory Board, and a Board of Auditors. Financial monitoring of the organisation is the responsibility of the Board of Auditors, which comprises a team of auditors, with at least one member being a member of BOCs, and is appointed by the BOCs.

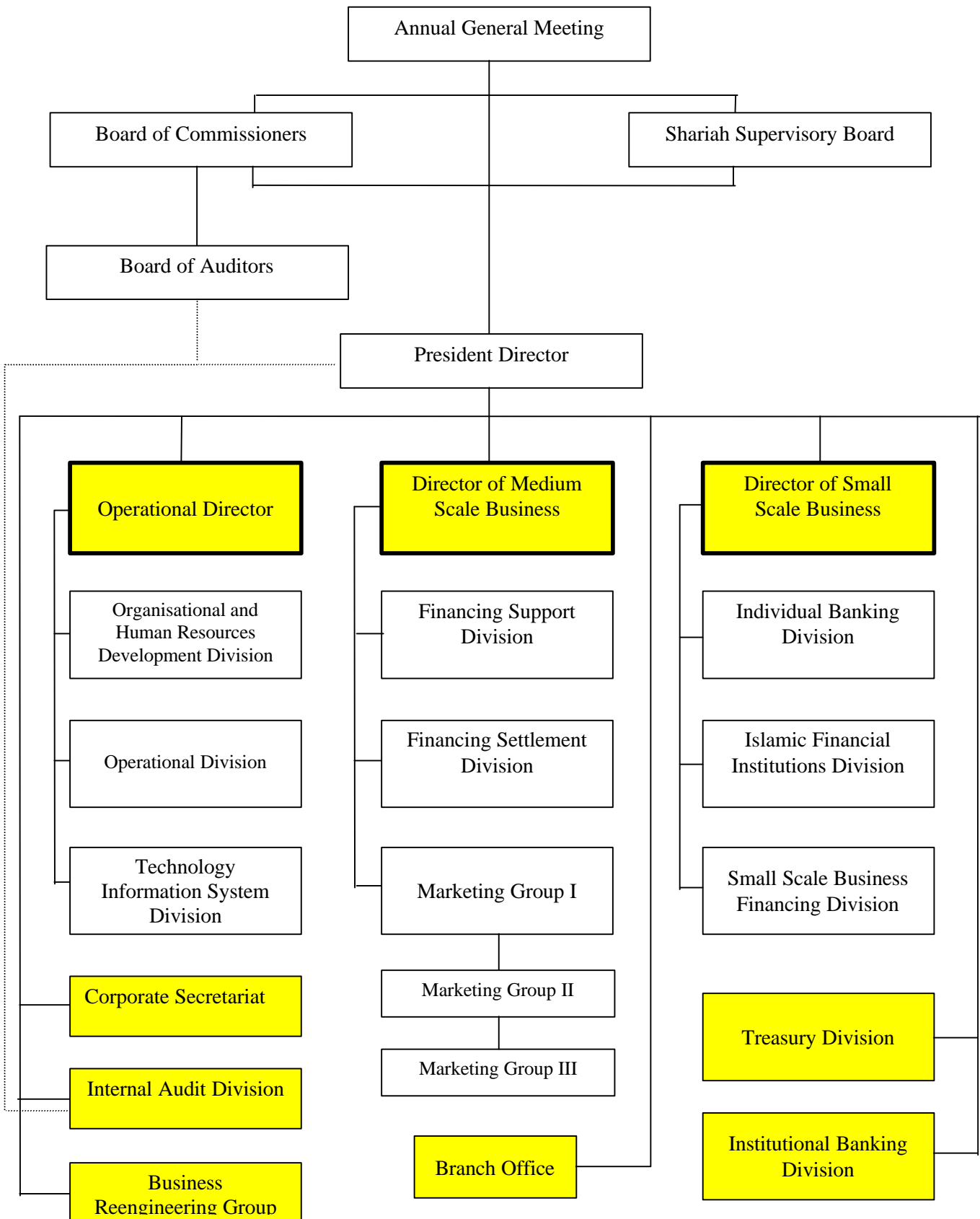
Unlike conventional banks, however, Islamic banks offer PLS accounts, among others, which do not guarantee a fixed certain return on investment deposits. This leads to a reluctance of deposit holders, who have no representation in the organisation, to use PLS accounts. The bank faces a similar problem on the assets side when it comes to investing on PLS (discussed in the introduction).

The structure of Islamic banks has been a major hindrance in the equity-based (or PLS) modes of financing. Most Islamic banks work as joint stock firms whose shares are easily tradable. Growth of PLS requires that the 'ownership rights' should not be easily transferable or tradable. Mutuals as prevalent in countries like UK may offer a working example of non-transferable and non-tradable ownership rights.

On the assets side, Islamic banks face a dilemma to extend financing on the PLS basis to firms in which broad policies, strategic plans, and day-to-day decisions are largely controlled by inside professional managers. While under PLS, Islamic banks share financial risk with the borrowing firms yet they do not have any controlling rights. The legal framework in which they operate does not recognise the special needs of Islamic banks. Thus a central problem is how to make borrowing firms accountable to the Islamic banks while maintaining the former's freedom, incentives and control over production and investment decisions.



Figure 1: Organisation of an Islamic Bank: Bank Muamalat



With Islamic banking being a recent phenomenon in Muslim countries, particularly in the Middle East, and in the wake of growing dissatisfaction with corporate governance systems all over the world, there is a need to define management and control functions vis-à-vis PLS arrangements. It is also important to give due attention to local cultures and business environments in Muslim countries. The West does not provide a satisfactory and universally acceptable corporate governance system that can be emulated in Muslim countries. Nevertheless, financial developments, especially increasing use of equity funding in the West, have important implications for Islamic banking.

The use of PLS as an acceptable mode of financing crucially depends on specification of management rights, claims and responsibilities on the one hand, and measurement of their performance through a system of control and compensation on the other.

### 3. Management and Control Defined

Participation in management is a natural form of control. However, management and control are distinctly different from each other as a firm may be controlled without actual participation in management. Thus, management is defined as initiation of projects (demand and feasibility studies, project proposals etc.) and implementation of these proposals by active involvement in the production process. Control on the other hand is defined as the right to ratify the initial proposals and supervise the projects either through internal monitoring or external mechanisms (Fama and Jensen, 1983).

The precise definition of management given above needs elaboration in terms of functions a manager performs. Here we use Radner's (1992) list of what managers do. First, they observe the environment and respond to past actions. Second, they process information and data and communicate it to other parties. Third, they make decisions. Fourth, they monitor the actions of other employees in the firm. Fifth, managers hire and fire employees. Sixth, they train and teach other managers and employees within the organisation. Seventh, they plan, which involves making proposals for resource utilisation. Eighth, they solve problems. Finally, they persuade, set goals, create the

values of the organisation, which provide the framework for other agents of the organisation to operate in.

Berle and Means list five ways to control a corporation: (i) control through almost complete ownership; (ii) majority control; (iii) control through a legal device without majority control; and (v) management control (Berle and Means, 1968, p. 67<sup>10</sup>). Control is basically exercise of authority. In the context of theory of the firm, management and control functions have not been separately defined perhaps because traditionally in owner-managed firms a single individual performs them. However, with the increasing complexity of business organisation, distinction between the two functions is important for allocation of these functions to those who can efficiently perform them. This distinction assumes even more importance with the increase in the size of the firm. Separation of ownership and management in large corporations causes conflict of interests between the former and the latter, giving rise to agency problems within organisational structure. Control of the firm in this context refers to curbing the agency problems between managers and owners/shareholders. Thus control implies the measures taken by shareholders to check managerial behaviour to make it in line with their (shareholders') interests. Appointment of Board of Directors (BODs) is an obvious step in this direction. However, given the possibility of collusion between managers and executive (inside) directors at the expense of shareholders' welfare, shareholders must be protected. Hence, control also entails curbing this agency problem. An implicit form of agency prevails in the form of entrenchment<sup>11</sup> on the part of management, which calls for further control measures to be taken by owners/shareholders. Thus control implies ensuring desired performance via supervision of management performance, and accountability of management to shareholders.

Table 1

| Control Mechanism           | Action   | Effectiveness  | Criticism  | Countries         |
|-----------------------------|--|--|--|-------------------|
| <u>Internal</u>             |  |  |  |                   |
| Board of Directors          | Supervision and ratification of decisions                | Large public and private companies   | In practice, the directors are rubber-stamps and serve management rather than shareholders | Common everywhere |
| Incentives                  | Profit-related remuneration packages, share options etc. | An active employment market for senior executives whose salary is determined by past performance |  | Germany, UK, USA  |
| <u>External</u>             |  |  |  |                   |
| Exit                        | Withdrawal of ownership by selling shares                | When ownership is diffused   |  | Common everywhere |
| Voice                       | Institutional activism                                   | Small closely held corporations and/or when ownership is concentrated                            |  | USA               |
| Regulation                  | Government action  | When market imperfections are widespread   |  | Common everywhere |
| Market in corporate control | Take-overs   | Well-developed stock markets   |  | UK, USA           |

### 3.1. Control Systems

Based on the source, control systems may be divided into internal and external. The former includes managerial remuneration and constitution of BODs. The markets for corporate control and managerial labour, product market competition, juridical constraints, and exit and voice strategies are examples of external control.

Management control, sometimes referred to as internal control, can be divided into financial and strategic control. The former refers to annual budgeting procedures, post performance procedures and manager incentive compensation linked to financial returns. The latter is characterised by a subjective evaluation based on relationships between corporate and business levels and the depth of understanding of business unit operations by corporate managers (Hitt, Hoskisson and Ireland, 1990). Financial control is thus ex post, objective, quantitative and short term, and strategic control is ex ante, qualitative, subjective and long term.

The BODs is “the institution to which managers are accountable, and the institution which is accountable before the law for the companies activities.”<sup>12</sup> The BODs is expected to “formulate corporate policy, approve strategic plans, authorise major transactions, declare dividends, and authorise the sale of additional securities... (It is) also expected to hire, advise, compensate, and if necessary, remove management; to arrange for succession; and to determine the size of the board and nominate new members, subject to approval by shareholders” (Blair, 1995, p. 56). Thus it is a measure of control, and comprises executive and non-executive directors. While the former are better suited for strategic control, the latter tend to specialise in financial control.

The classical method of control proposed by the agency theory is a system of incentives that aligns interests of shareholders and managers. As equity ownership of management reduces agency problems (Jensen, 1989), this may serve as a control parameter. Another incentive-based control device is profit/performance-related remuneration packages for managers. Incentives strategy includes salary incentives, share options, executive presentations and discussions, and active employment market for senior executives whose salary may be determined by past performance. A recent development that

recognises this control mechanism is the emergence of Management Buyouts (MBOs). There is growing empirical evidence that incentives per se do not significantly reduce agency problems (Canyon and Leech, 1994; and Ogden and Watson, 1996). Other complimentary control devices required by financiers of buy-outs include monthly financial reports, nomination of directors, equity ratchets (contingent contracts by which management's equity stake could be increased or reduced depending upon whether predetermined performance targets were met), nomination of chairman, and various rules relating to the need to obtain financiers' approval for certain actions (Wright, Thompson and Robbie, 1992).

The exit strategy involves withdrawal of stake/ownership by selling shares and is feasible if the ownership is diffused. If managers abuse their positions or fail to perform well the stock price of their firm will fall attracting buyers who would acquire the firm and correct abuses (the market in corporate control). The market in corporate control requires well-developed stock markets and results in hostile take-overs.

The voice strategy is effective when the ownership is concentrated, and takes the form of institutional activism.

The regulation refers to supervision of banking and other financial institutions by government authority that assesses and monitors the financial performance of such organisations. Such a control may be maintained through evaluation of management on the basis of (i) technical competence, leadership and administrative ability, (ii) compliance with regulations and statutes, (iii) ability to plan and respond to changing circumstances, (iv) adequacy of and compliance with internal policies, (v) depth and succession, (vi) tendencies towards self-dealing, and (vii) demonstrated willingness to serve the legitimate needs of the community<sup>13</sup>. Table 1 presents a summary of these strategies.

### **3.2. Management and Control Combined**

There are four basic ingredients of an organisational structure: authority, risk, reward, and responsibility. Possession of authority is considered as a basic component of

ownership. The investment of resources makes the owners residual claimant on the return from the business activity in which decision-making (responsibility) is delegated on to the managers. This may create asymmetry of incentives between owners and managers (the agency problem), which necessitates a mechanism for control. Thus control stems ownership of resources in risky business activities managed by salaried managers. Making the managers share risk with the owners can mitigate the agency problem. Figure 1 depicts how authority, responsibility, risk and reward are inter-related. Figure 2 shows how composition of management and control changes with increase in the volume of these functions. It is evident from the figures that risk and reward sharing common to management and control functions when both owners and managers are residual claimants. Perhaps due to this sharing of risk and reward, complete specialisation of management and control is rare in modern corporations.

Figure 1: Management and Control in an Organisation

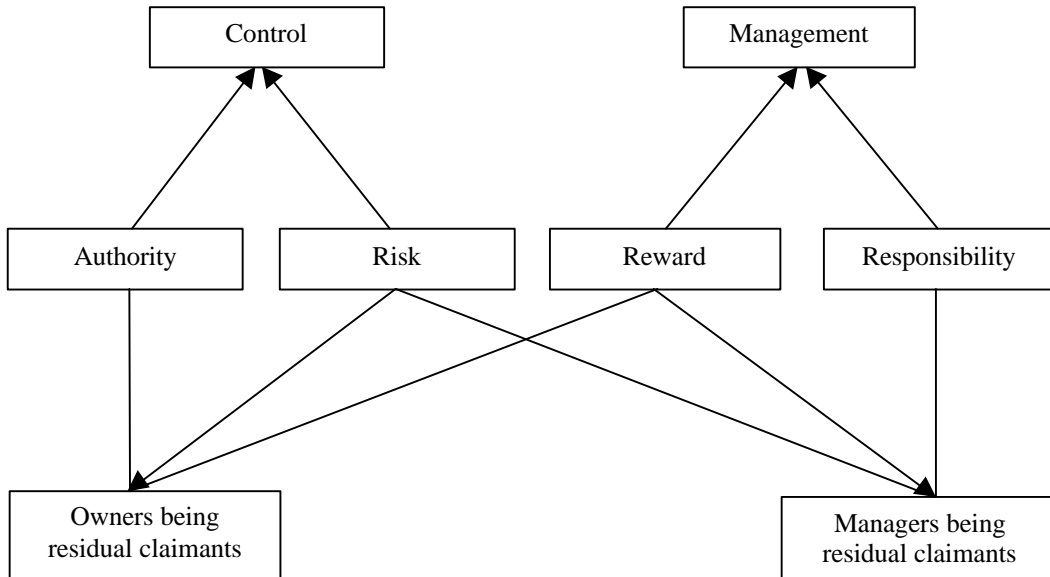
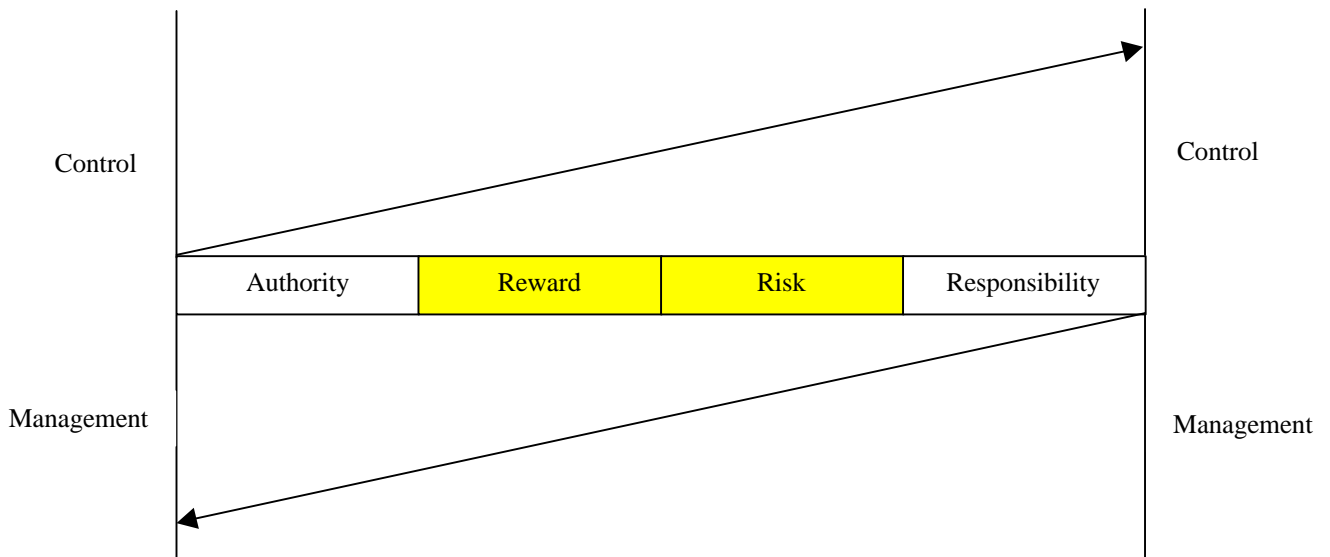


Figure 2: Management and Control Functions





### **3.3. PLS and Management & Control Rights**

In a typical PLS arrangement, an Islamic bank provides the risk capital to a firm in which professional managers are responsible for making strategic and operational decisions. The bank shares in profits and is liable to any financial loss. There is no serious problem with this arrangement if the bank is able, and is allowed, to monitor business operations of the firm. However, proper monitoring mechanisms are yet to be devised for PLS, especially in case of Mudaraba that does not provide any control rights to the financier (the Islamic bank in this case). Fiqh literature on this issue is quite out-of-date and needs serious reconsideration. For example, Saleh (1986) lists three rights and one responsibility of the financier in a Mudaraba arrangement. The rights include ensuring that the borrowing entrepreneur (firm) complies with the terms of the contract, sharing profits, and limited liability in case of loss. The sole responsibility is handing over the Mudaraba capital. He also outlines two rights and two responsibilities of the borrower. The rights include conducting the business with an appropriate degree of freedom, and accounting decisions. The responsibilities are compliance with the terms of the contract, and liquidation of the Mudaraba business at the end of the contract.

The modern use of Mudaraba as a mode of financing obviously requires more than such preliminary specification of rights and responsibilities. There is a need for construction of standardised PLS contracts, or bylaws, in the light of the legal frameworks of Muslim countries. A prominent feature of these bylaws should be definition of the rights and obligations of various officers or groups within the organisational structure. Similar bylaws should delineate the clauses related to performance of the borrowing firm compared with other firms in the same sector and, possibly, other firms.

In Pakistan, Mudaraba laws attempt to provide more or less what we suggest here. The Mudaraba Companies and Mudarabas (Floatation and Control) Ordinance 1980, the Mudaraba Rules 1981, Prudential Regulations imposed by the State Bank of Pakistan, and the Guidelines for Issuance of Musharaka Certificates for Mudarabas provide a basic legal framework, which other Muslim countries can emulate with changes and modifications as required by their own legal frameworks.

For the reasons outlined in sections 1 and 2 above, it is often asserted that agency problems are more severe in Islamic banks than conventional banks and Non Bank Financial Institutions (NBFIs). Modern finance literature provides some solutions. These include monitoring and bonding arrangements (Jensen and Meckling, 1976), separation of management (initiation and implementation of decisions) and control (ratification and monitoring of decisions) (Fama and Jensen, 1983), and staging of capital provision (Sahlman, 1990). Other control measures as discussed above also apply.

The first two solutions are with reference to agency problems within financial structure of the firm; while the third refers to venture capital financing. These solutions are equally relevant to the agency problems faced by Islamic banks using PLS as a primary mode of financing. However, these solutions are quite general. The control mechanisms given in Table 1 are extensions of these three basic solutions, and have direct relevance to the practice of PLS in Islamic banking.

If basic management functions are data collection and processing, and provision of training to workers (employees) so as to keep pace with ever-increasing business environment (Williamson, 1986, p. 34), then control devices like (i) redundancy threats, (ii) external data checks, (iii) creation of overlapping responsibility, (iv) counter-biases, (v) re-organisation so as to keep the hierarchy flat, and (vi) coding may be useful (Downs, 1966, p. 78-90).

#### 4. Proposals for Organisational Structure of Islamic Banks

Given that Stock markets in Muslim countries are underdeveloped and, in most cases, volatile, it may help if Islamic banks are set up as private limited companies or as mutual organisations. If set up as private limited companies, their owners will not be shareholders from the general public; rather large institutions and entrepreneurs may provide initial capital. On the other hand, Islamic banks opting for mutual organisational form will have more democratic character enabling its depositors to enjoy some ownership rights. Alternatively, a mix of these organisational forms may prove useful.

The lack of liquidity as posed by PLS on the liabilities side may be tackled by encouraging pension funds, insurance companies and other such organisations to invest in Islamic banks. As such organisations aim at long-term growth, and not short-term capital gains, Islamic banks will not be much vulnerable to unexpected withdrawals or liquidity crises.

In the Islamic banks already established as public limited companies (PLCs), BODs should comprise outside and independent directors along with executive directors<sup>14</sup>.

The suggestion receives a mix reaction. Some argue that internal governance may stifle growth and innovation (Mayer, 1997). Others find no significant relationship between firm performance and board composition. Some relate the importance of corporate governance to market imperfections (Llewellyn and Holmes, 1997). However, particular directors on various committees (finance, long-term investment or strategic development, audit, compensation, and nominating) may have marginal effect (Klein, 1998).

Public confidence in PLS can only be established if ownership and management of Islamic banks show their own commitment to this principle. An important step in this direction will be introduction of profit-related pay for managers and employee share ownership plans (ESOPs). This is expected not only to have a positive effect on the productivity of management and other employees, but will send a healthy signal to the general public indicating commitment of the owners and managers to the principle of PLS.

## 5. Proposals for Growth of PLS on Assets Side

As mentioned earlier, Islamic banks should play a role similar to that of institutional investors. This requires adequate changes in business operations and investment strategies of the Islamic banks to accommodate their dual role of investors and shareholders in the business of the borrowing firms<sup>15</sup>. Furthermore, banking regulations need serious overhauling. In most Muslim countries, banks are either prohibited from taking controlling rights in corporations (regulated so that taking control blocks would be costly) or structured so that managers of the borrowing firms control their decision-

making. These laws, along with hostile attitude of the Mudaraba contract towards capitalist, have been a major hindrance in the adoption of PLS by Islamic banks. Hence reforms in banking regulations are required to balance the management and control rights between Islamic banks and managers of the companies they invest in.

A simple model of how PLS may function on the assets side of Islamic banks is depicted in Figure 1. We propose an organisational structure based on venture capital, henceforth called venture capital organisation (VCO), in which a group of Islamic banks establishes a venture capital fund<sup>16</sup> to invest in troubled companies or acquire public corporations facing privatisation. Banking regulations may restrict the extent of Islamic banks' equity share in such companies. Hence, it will help if they hold only a small proportion of equity along with the management, and the institutional investors. The model here resembles with a leveraged buy-out (LBO) organisation (see, for example, Jensen, 1989). The major difference between our model and Jensen's LBO organisation, however, is that the former is not a highly leveraged company as the latter, by definition, is. Furthermore, debt instruments to be used here are not interest-based; rather they are Islamically accepted modes of financing like leasing and mark-up etc. While these debt instruments have disciplinary effect on the management, in practice they are not as harsh as interest-bearing debt can prove to be.

The VCO provides a balance of power between management and other owners who have a financial stake in the firm. The shareholders are not just passive capitalists but share decision-making with the management when it comes to running the organisation.

The value creation by a VCO will be much better than other organisations. For example in the USA, average total premium to public shareholders ranges from 40% to 56%. In buy-outs (similar to the proposed VCO), on the other hand, at the time of exit (which occurs on average 2.7 years after the original acquisition), total shareholder value increases by an average of 235% or nearly 100% above market adjusted returns over the same period (Kaplan, 1989). There are a number of sources of value creation in the VCO, namely, managerial (Zahra<sup>17</sup>, 1995), operational, and institutional.

Managers, who also hold shares in the VCO, will be more productive as they possess private information about the projects because perhaps they already have been professionally associated with the ventures. In addition, joint ownership between managers and other shareholders will result in alignment of interests between them, mitigating the agency problem. Furthermore, in a VCO strategic controls will replace financial controls because all the shareholders (managers, Islamic banks, and institutional investors) will be intimately involved in managing the company and making key decisions. These controls encourage long term investments in projects, which influence the firm's value.

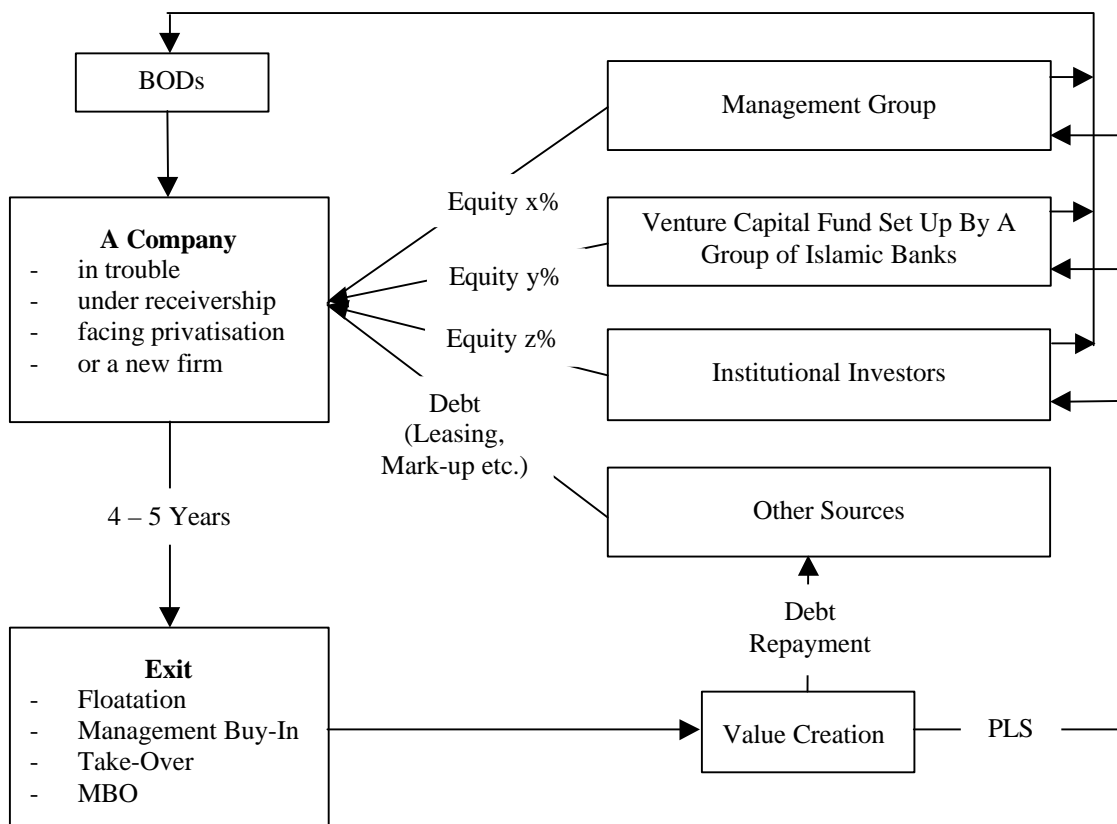
In a VCO, information sharing will be less costly, quickening the pace of decision-making.

Involvement of the institutional investors serves a positive monitoring function. Institutional investors in a VCO will closely monitor managerial actions, thus reducing agency costs.

The following points, however, should be noted:

1. Venture capital financing for start-ups is very risky, and even in America where it is considered to be highly successful, the failure rate among the companies chosen for investment is very high. To diversify risk, venture capitalists normally invest in 20 to 30 companies, depending upon their managerial capability.
2. The proposed organisational form is more likely to be transitional<sup>18</sup>.

Figure 4: PLS on Assets Side: Setting up a VCO



In addition to VCO, Islamic banks may invest in public corporations on lines of universal banking that results in (i) improved information gathering and monitoring; (ii) amelioration of conflicts between various claimants on the firm; (iii) diversification benefits; and (iv) more effective signalling (Calomiris and Ramirez, 1996). Gompers and Lerner argue, “An investment bank that is underwriting a security for a company in which it holds a venture capital investment will have substantial information on the company: venture capitalists sit on boards and advise managers.”<sup>19</sup>

Not all investments of Islamic banks, however, will be through VCO or the arrangements like universal banking. such a vehicle. For monitoring other investments, Islamic banks should jointly set up a monitoring agency a major task of which would be collecting data and other relevant information about the firms in which Islamic banks have stakes. If not feasible due to free-rider problem, individual banks may create separate monitoring sections in their credit departments. This requires recruitment of a couple of credit/investment analysts and should not be too costly. In Muslim countries where most banks have no or the least developed corporate finance departments, this suggestion may seem premature. But creation of an enabling environment for successful functioning of PLS will eventually necessitate such a development.

There is a need for devising a voluntary ‘code of best practice’ and ‘statement of compliance’ by the Islamic banks (similar to one suggested by Cadbury Report in England for the UK corporate sector). However, voluntary activities can only bear fruit if backed by proper government action and legislation. Any organisational change in banking sector is unlikely unless governments of Muslim countries take this issue seriously. There is a need for provision of incentives to the institutions participating in PLS.

## 6. Conclusion

In a perfect world in which partners, in whatever form, are honest with each other the issue of management and control becomes redundant. The real world is not like this and therefore the issues raised here are central to the functioning of Islamic financial institutions and, more importantly, their continued development and profitability. Without the types of management and control discussed here, Islamic banks will persist in taking the easy and risk averse route and avoid profit and loss sharing contracts. The incentive to cheat must be eliminated, the desire to withhold information must be negligible and systems must be put in place which allow efficient and open profit and loss share instruments to develop.

This paper has exposed the key issues involved in management and control in Islamic banks; it has identified the differences with conventional banking practices and made suggestions as to how venture capital can be developed in an Islamic setting, without fear of the system collapsing or being restricted in its development.



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## Notes

<sup>1</sup> The emphasis on PLS stems from the Islamic ban on interest. Many would argue that theoretical models of Islamic banking and finance exaggerate the usefulness of PLS; but still as a matter of fact PLS is the dominant mode of financing.

<sup>2</sup> Mudaraba is a limited liability contract between two or more parties in which one party provides capital to other(s) to start a joint venture to share in profits, according to a mutually agreed upon ratio. The loss, if incurs, is borne by the capital provider. Musharaka, literally meaning partnership, is a more general form of PLS in which all the contracting parties invest to share in profits according to a pre-determined ratio, and to share losses according to their investment shares.

<sup>3</sup> Islamic mark-up combines the features of a deferred payment sale and a mark-up on price. A bank buys from the market to sell it to clients on a mark-up on the purchased price. The client, in turn, pays in instalments.

<sup>4</sup> Even recent developments in Islamic banking have failed to spur the use of PLS. For example, Islami Bank Bangladesh, Sudanese Islamic Bank, Tadamon Islamic Bank, Qatar Islamic Bank, and Bank Islam Malaysia Berhad have so far failed to use Mudaraba as a mode of financing. Islamic banking in Europe (especially in Switzerland and Britain) is also heavily biased in favour of trade finance and project finance on *murabaha* basis. PLS has yet to attract a successful practitioner in Europe.

<sup>5</sup> PLS contracts can be thought of as sharecropping contracts (for details, see Dar, 1997). Adam Smith, Marshall and others questioned the efficiency of such contracts. Yet recent articles have identified issues such as capital constraints in explaining why such contracts may work (see, for example, Laffont, Jacques and Matoussi, 1995).

<sup>6</sup> The Mudaraba managers face no restrictions from certificate holders. However, stock markets and different government authorities (Corporate Law Authority and the State Bank of Pakistan) monitor them externally to ensure transparency in business.

<sup>7</sup> Alternatively, Islamic banks could maintain a large cash reserve to fund short-term projects. But this is rejected on efficiency grounds.

<sup>8</sup> For theoretical studies, see Alchian and Demsetz, 1972; and Fama and Jensen, 1983. Blair (1995) cites empirical studies on take-overs, leveraged buy-outs, and employment ownership plans.

<sup>9</sup> This BODs is in fact a management team headed by a CEO (President Director in this case).

<sup>10</sup> Revised (1968) edition of *The Modern Corporation and Private Property* by Harcourt, Brace & World, Inc., New York.

<sup>11</sup> Entrenchment by managers may involve adopting strategies the success of which depends on their own particular skills, and establishing implicit contracts with employees and suppliers on personal basis (for details, see Schleifer and Vishny, 1988; Walsh and Seward, 1990).

<sup>12</sup> Oxford Analytica Limited (1992, p. 7).

<sup>13</sup> See Errico and Farahbaksh (1998).

<sup>14</sup> Outside directors are those “who are not employees, former employees, former officers, or persons who receive or have received compensation from the company for any services other than as a director.” Independent directors are those “who have no other affiliation or link to the company other than as shareholders and board members” (Blair, 1995, p. 80-81).

<sup>15</sup> In the Anglo-Saxon world, this suggestion can easily be dismissed as in the UK and USA banks face severe restrictions to intervene in the management of the businesses they invest in. However, Germanic and Japanese models of banking are relevant here.

<sup>16</sup> Mudarabas in Pakistan are an example of this kind. Many banks have set up their own Mudaraba funds; but their primary investments are in leasing and mark-up.

<sup>17</sup> Zahra (1995) lists a number of sources of value creation in MBOs, which are equally relevant for the proposed VCO.

<sup>18</sup> Kaplan (1991) notes that more than half of the 183 LBOs he studies were no longer privately owned seven years after the buy-out transaction.

<sup>19</sup> Gompers and Lerner (1999) p. 6.

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