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The Revitalization of Islamic Profit-and-loss Sharing

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ABSTRACT

Initially the raison d'être of modern Islamic finance, profit-and-loss sharing (PLS) now accounts for only about 5% of the operations of Islamic financial institutions. This paper argues that PLS (*muḏāraba* and *mushāraka*) can and should be revitalized. It addresses the obstacles that have hindered its development, and proposes solutions based in part on the lessons of the American venture capital experience (particularly in Silicon Valley). The paper introduces some concepts and principles of venture capital, and considers the experience and strategies of American banks active in partnership finance. The basic argument is that successful entrepreneurial subcultures can be created in unlikely places through the judicious use of appropriate methods and incentives. While the logic and principles of venture capital differ sharply from those of classical banking, Islamic financial institutions can build their PLS units and skills while minimizing mistakes, fraud, and conflicts of interest. Finally, the paper discusses the need to adapt Western venture capital practices to the Islamic religious, social, and economic environment.

I. INTRODUCTION

The great disappointment of Islamic finance is that despite a growth rate exceeding 15% a year, the relative share of profit-and-loss sharing (PLS)[i] operations such as *muḏāraba* or *mushāraka* has been steadily dwindling. Initially the raison d'être of the industry, PLS now accounts for less than 10% of the operations of Islamic financial institutions.[ii] The vast majority of Islamic deals are in the areas of trade finance, markup operations (*murābaẖa*), and leasing (*ijāra*). Such modes of financing, while generally accepted by Islamic scholars—sometimes without great enthusiasm, either because they do not bring significant social and economic benefits to the community, or because they mirror conventional finance—were once perceived as temporary, and designed to allow banks to generate income while building resources and experience in partnership finance. But when early PLS experiences failed, most Islamic banks responded with policies ranging from benign neglect to outright abandonment of partnership finance.

Today there is a vast gap between the theory and the reality of Islamic PLS. On the one hand, Islamic banks keep reaffirming their commitment to partnership finance, the literature on the subject is abundant, and indeed Islamic finance is often equated with profit-and-loss sharing. On the other hand, the share of PLS in Islamic finance keeps falling, and few institutions seem serious about reversing the trend. Indeed, there is an implicit consensus that attempts at partnership finance are doomed to failure because the required skills and institutions, let alone the appropriate culture and mentalities, are lacking in the Islamic world.

The theoretical foundations of contemporary Islamic PLS were established in the mid-to-late 1970s—the formative years of modern Islamic finance.[iii] Although for centuries the dominant financial practice within the Islamic world, PLS had by then been largely displaced by conventional, interest-based lending. Thus, *muḏāraba* and *mushāraka* had to be reformulated by scholars to fit the contemporary environment. In those years, venture capital (outside the Islamic world) was still in its infancy and was therefore of little use in the updating effort. Yet in recent years, the boom in venture capital, in particular in California's Silicon Valley, has been accompanied by vast advances in our understanding of partnership finance.[iv] This boom has allowed the development, if not of a "science" of venture capital, at least of a corpus of principles, rules of thumb, and best practices.[v]

Unfortunately, these advances have not been incorporated in the scholarship on Islamic partnership finance. While abundant, this scholarship is highly abstract, and still based on the worldview and economic assumptions of the 1970s. It barely touches on the causes of the early failures, and offers scant examination of actual case studies and few practical recommendations.

This paper argues that recent advances in our understanding of venture capital—based in particular on the author's work on the Silicon Valley phenomenon—could be usefully adapted to an Islamic environment, and serve to revitalize Islamic PLS. This paper addresses the role of partnership finance in Islam and in the global economy, and draws lessons from the failure of recent Islamic PLS experiments. It also discusses the institutional and cultural

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conditions that have allowed partnership finance to thrive, and suggests ways of adapting the best practices of modern venture capitalism to the religious, institutional, and cultural context of Islam.

II. Partnership Finance in Islam and in the Global Economy

Mudāraba and *mushāraka* are at once the most Islamically authentic and the most socially and economically useful forms of Islamic finance. They are also ideally suited to the global economy. The difference between the two is one of mechanics, not of principle. The traditional *mudāraba* is a contract between two parties whereby one party, the *rabb al-māl* or *sāhib al-māl* (beneficial owner or the sleeping partner), entrusts money to the other party, the *mudārib* (managing trustee). The *mudārib* is to use the money according to clearly defined conditions, and after the business transaction is concluded return the principal and a pre-agreed share of the profit to the *rabb al-māl*. The *mudāraba* mechanism was common in early Islam, and later inspired the French system of "commandite."

The traditional *mushāraka* is a partnership, normally of limited duration, formed to carry out a specific project. Participation in a *mushāraka* can either be in a new project, or in an existing one, where additional funds are provided as needed, in exchange for an equity stake. Profits and losses are shared in proportion to the capital contribution, adjusted for contribution to the management effort and other factors. The primary difference with the *mudāraba* is that the *mushāraka* entails an equity position in the venture.

Why is profit-and-loss sharing considered the cornerstone of Islamic finance? First, *mudāraba* and *mushāraka* have their roots in the Islamic tradition.[vi] In the days of the Prophet Muhammad, it was common for wealthy merchants to finance the caravan trade. They would share in the profits of a successful operation, but could also lose all or part of their investment if, for example, the merchandise was damaged, stolen, lost, or sold for less than its cost. In recent centuries, PLS had fallen into obsolescence. By the nineteenth century, it was all but superseded by Western-style interest-based banking.

Second, it goes to the root of traditional misgivings (common to a number of religions and societies) about interest.[vii] Since risk is shared by the lender and the borrower, profit-and-loss sharing is just and equitable—a rich lender cannot take advantage of a penniless borrower. Third, it is conducive to a dynamic economy in which the benefits of growth are shared by the community at large. Indeed, the essence of Islamic finance is that money be used for productive purposes: "Islamic banks have a moral and social responsibility toward their economies by investing in long-term projects."[viii]

Partnership finance also happens to be fully compatible with the changing financial environment as well as the norms and principles of the global economy. The catch-all term "globalization" encompasses a wide range of phenomena that have appeared since the end of the Cold War and the emergence of a unipolar world: deregulation and increased openness of markets; the growing role of international finance; and the acceleration of technological change; among others.[ix] More importantly for our purpose, banking worldwide has since the 1970s undergone profound changes.[x] Competitive pressures have intensified and lines within the financial sector are increasingly blurred. The cozy world of national oligopolies started fading with the erosion of the near-monopoly of banks on the intermediation process (i.e., the conversion of savings into loans).[xi] With commercial banks in competition with securities firms, insurance companies, mutual funds, pension funds, and other financial services companies, investors face a growing range of choices.[xii] Financial institutions rely increasingly on fee (as opposed to interest) income, and entrepreneurial banking is on the rise.[xiii]

In much of the Islamic world, the regional economy that characterized the 1970s has broken down.[xiv] Less autonomy and fewer options are now available to national governments. Unless they prefer autarky, countries are forced to conform to the dictates of the global economy. Given that most countries are heavily indebted,[xv] raising funds in the international markets, or obtaining aid from the International Monetary Fund or the World Bank, requires adopting policies conforming to the new international orthodoxy—the "Washington consensus"—which consists of a number of inter-related components: economic austerity, liberalization of trade and capital flows, privatization, dismantling of the public sector, etc.[xvi]

On the issue of economic growth, the new orthodoxy holds that development and job creation should come primarily from the private sector: the state should be downsized, the economy should be deregulated, and government-owned companies should be privatized.[xvii] The role of the government should be limited to facilitating the growth of the private sector, the modernization of financial markets, and more generally the encouragement of entrepreneurship. In the wake of the Asian financial crisis, which started in July 1997, the new consensus has expanded to include the elimination of "crony capitalism," the oligarchic system by which capitalists are not really risk-taking entrepreneurs but rather "rent-seekers" who take advantage of their close ties to political leaders.[xviii]

In this new world economy, partnership finance, with its reliance on free markets and entrepreneurship, holds a place of choice. Equity-based solutions are preferred to resolve the problems of poverty and economic growth. Partnership finance is also perceived as more democratic than conventional lending because it empowers people with potential but no collateral. The U.S. economy has been held up as an exemplar of what all other countries should do. Indeed, much of the credit for the success of the American economy in the 1990s has gone to entrepreneurship and those institutions—chief among them venture capitalism—that have allowed it to thrive. Not surprisingly, the promotion of venture capital has figured prominently in attempts by countries such as Germany and Japan to unshackle their economies and promote growth.[xix] And every emerging market, including in the Islamic world, is keen on creating its own "Silicon Valley" that would emphasize entrepreneurship and high technology.[xx]

A renewed emphasis on PLS may provide an adequate response to the numerous challenges faced by Islamic financial institutions themselves. They typically operate within overbanked environments; lack the size, resources, and product base to compete internationally; suffer from an overhang of bad loans; and lag behind their Western counterparts in technology and expertise—all at a time when Islamic countries are urged to liberalize their financial systems and open them up to foreign competition before these problems are fully addressed.[xxi] The original Islamic banking philosophy is fully consistent at once with the principles of the global economy—equity orientation, market-led growth, etc.—and the innovative logic of international finance. Insofar as partnership finance was the initial raison d'être of Islamic banks, its revitalization could provide Islamic banks with a significant competitive advantage. In the absence of effective capital markets, venture capital can provide long-term funding for those entrepreneurs who would otherwise not have access to conventional banking loans.[xxii] Partnership finance also holds the potential, through such instruments as *muḏāraba* and *mushāraka* certificates, of a secondary market and, over time, of a truly Islamic capital market.

III. Parallels between Western Venture Capital and Islamic Profit-and-loss Sharing

Contemporary Islamic writers have emphasized the "modernity" of the Islamic profit-and-loss philosophy since it is similar to financing techniques that have emerged only recently in the West. In Islam, partnership finance is seen as more than mere financing—it is central to creating economic added value and giving money back to the community.[xxiii] Similarly, modern venture capital in the West plays a central role in the very process of economic transformation. In the words of one author: "Venture capitalists play many roles (...). They are intermediaries between the vast pool of private and institutional wealth that is the fuel for all economic activity and the most hazardous use for investment capital: the formation of new companies. Their ability to assess and manage enormous risks, and to wring from them exceptional returns, is a critical element in America's ability to mobilize its entrepreneurial talent. They are brokers of risk, agents of a new style of financial service that is crucial to our ability to transfer resources from fading industries and technologies to the goods and services that will dominate a restructured world economy in the next century."[xxiv]

The philosophy of partnership finance—whether in its modern venture capital or in its Islamic PLS variant—is that the "lender" should share the risk and rewards of the "borrower." This section discusses the parallels between Islamic profit-and-loss sharing and American-style venture capital, dispelling in the process common myths and misperceptions.

A. Differences with Conventional Lending

Like bankers and other financiers, practitioners of partnership finance are engaged in a process of financial intermediation: they turn savings into investments, collecting money from people who have excess savings and handing it to businesses in need of financing. But the fundamental difference is that in partnership finance the financial institution is not a lender but a partner: instead of lending money at a fixed rate of return, it forms a partnership with the borrower, sharing in a venture's profits and losses. More specifically, partnership finance differs from conventional banking in the following respects:

1. Involvement in Management

Conventional lenders are solely preoccupied with the repayment of the loan. They are seldom involved (except in rare cases of repayment difficulties) in management and business guidance. In contrast, partnership financiers are not passive investors, but have an active and vested interest in making the venture as profitable as possible. They seek to add value through their knowledge and experience.

2. Expectations, Concerns, and Motivations

Conventional lenders are mostly concerned with creditworthiness—the ability of borrowers to repay loans along with a specified interest. Such lending, usually collateral-based, is inherently conservative since it favors established businesses, and is only indirectly concerned with the success of the ventures it finances. This is why conventional lenders usually provide "expansion capital" for going, successful concerns. In contrast, the focus of partnership finance is on "creative capital," usually for funding new ventures from scratch or for major transformations in the size or scope of an existing firm. Unlike conventional lenders, partnership financiers link their own fate to the success of the projects they finance. A capital-poor, but promising, entrepreneur can obtain financing that conventional lenders would not normally provide.

3. Time Horizon

Most traditional lending is short-term. In contrast, partnership finance is long-term and involves "patient capital." Indeed, partnership finance offers the potential to unleash the entrepreneurial impulse by freeing the entrepreneur from the pressures and preoccupations of servicing a conventional short-term loan.

B. The Participants in Partnership Finance

There are three sets of participants in partnership finance: the investors who put up the money, the professionals who select and supervise the investments (the venture capitalists), and the entrepreneurs. The investors can be individuals, institutional investors (private and public pension funds, endowment funds, foundations, etc.). Their funds in turn are managed by venture capitalists who scout and monitor start-ups or young, rapidly growing companies.

Yet the lines are often blurred. Indeed, one of the founding principles of modern Islamic banking is the "double *muḏāraba*." In the words of Frank Vogel, "A first-tier *muḏāraba* is created when investors (we shall call them 'depositors') place their capital with an Islamic bank, fund, or other financial institution, which here acts as the *muḏārib* or working partner. The financial institution or *muḏārib* in turn invests these funds with entrepreneurs (the equivalent of a conventional bank's borrowers) by means of second-tier *muḏārabas*, in which the Islamic financial institution now has the role of capital investor."[xxv] In addition, the bank or the venture capitalist usually invests its own funds in addition to those collected from investors or depositors.

C. Structuring Transactions

American venture capital firms usually operate through specific venture capital funds. Each fund is comprised of limited and general partners. Limited partners are passive investors—thus akin to depositors in an Islamic bank—whereas general partners play an active role in managing the fund and are compensated accordingly. Under the most common arrangement, the venture firm distributes 80% of the profits from a fund back to investors, while the partners split the other 20%. The firms generally collect annual management fees in the neighborhood of 2% of the committed capital. A successful venture capital firm usually raises funds in rapid succession in order to provide more opportunities for existing and new investors. Each fund—which typically has a specific focus, based on specific industries, regions, stages of development, etc.—is managed separately and has its own limited and general partners. Usually, a fund is organized as a fixed-life partnership (ten years, for example). It is capitalized by commitments of capital from the limited partners. Once the partnership has reached its target size, the partnership is closed to further investment from new investors (or even existing investors), so the fund has a fixed capital pool from which to make its investments.

In Islamic banks, the liability-side of the balance sheet is not managed in uniform fashion. Most banks offer three types of accounts: non-remunerated demand deposits (for transaction purposes), savings accounts (for precautionary purposes), and investment accounts (for profit-making purposes). In theory, only the investment accounts correspond to PLS operations. Depositors can reap profits from such operations, but risk losing money if investments perform poorly. But in some Islamic banks, the return paid on investment accounts is determined by the yield obtained from all activities of the bank. After deducting administrative costs such as wages, provision, and capital depreciation, the bank pools the yields obtained from all ventures, and the depositors, as a group, share the net profits with the bank according to a predetermined ratio, which cannot be modified for the duration of the contract. In addition, different banks have different policies concerning the calculation and disbursement of profits. Some do it monthly, others quarterly, and others still semi-annually or even annually.[xxvi]

Many institutions also offer special investment accounts, which are linked to specific ventures. These are usually reserved to institutional investors or high-net-worth individuals. In that respect, they are very similar to the limited partnerships offered by American venture capital firms.

D. The Pragmatism of Partnership Finance

The American venture capital industry epitomizes pragmatism. It began in the most informal fashion, when wealthy individuals such as Laurance Rockefeller or John Whitney took chances financing risky start-ups. The industry then went through a lengthy process of trial-and-error before certain structures and practices took shape. By the 1960s, venture capitalism had become a distinct, if small, component of the financial services industry. In the 1980s and especially the 1990s, it experienced a veritable boom, becoming an increasingly important and sophisticated financing tool for a variety of companies.[xxvii] Firms such as Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft, Genentech, and Netscape received venture capital early in their development. The center of the industry is Silicon Valley in Northern California, but venture capitalists are now active in all parts of the world.

The most common type of venture capital firm is the "private independent firm," with no affiliation with any other financial institution. Increasingly, one can find venture capital firms that are affiliates or subsidiaries of a commercial bank, investment bank, or insurance company and make investments on behalf of outside investors. A third category comprises the subsidiaries of non-financial, industrial corporations that make investments on behalf of the parent itself.

The rules and principles of Islamic PLS were initially quite flexible, though an increased degree of formalism was later introduced. In the days of the Prophet, the religious injunctions stressed the sanctity of contracts, the need to put down financial commitments in writing, and the importance of ethical behavior. As the Islamic world expanded and trade flourished, *muḏāraba* contracts were codified by medieval jurists and could take on extreme complexity. Different *fiqh* (jurisprudence) traditions later brought their own biases to partnership finance. Hanafis and Hanbalis argued, for example, that the profit from a *muḏāraba* transaction could be shared only when the activity was completed and the financier had been reimbursed his principal, while Malikis and Shafiis permitted the distribution of profits even before the operation was completed and the principal reimbursed.[xxviii]

Another element of flexibility is provided by the existence of financial instruments and mechanisms that can complement Islamic PLS. Thus the *qard hasan* (interest-free loan or "good loan") can be used to tide over an entrepreneur facing difficulty. And most Islamic banks have a *zakat* fund (based on the Islamic obligation of *zakat* [almsgiving], one of the five pillars of Islam) on which they can draw to relieve distressed debtors.[xxix]

As for the adaptation of ancient financing techniques to a contemporary environment, two approaches are possible. Traditional scholars tend to adopt a literalist or legalistic approach, insisting on strict adherence to medieval rules and practices, whereas modernists try to uncover the spirit, or the "moral economy," behind formal rules. The "moral economy" of Islamic PLS is founded on the need for fairness in sharing the risk inherent in any business venture. Only a few rigid principles follow: the division of profits between the two parties must necessarily be on a proportional basis and cannot be a lump-sum or guaranteed return; the *rabb al-māl* is not liable for losses beyond the capital he has contributed; the *muḏārib* does not share in any losses except for the loss of his time and efforts (but in case of negligence or mismanagement, the entrepreneur may be responsible for the financial loss and be obliged to compensate the financier); the financier cannot require any guarantee, such as security and collateral, from the entrepreneur in order to secure his capital against an eventual loss. Beyond such principles, whatever is serviceable is allowed, as long of course as other religious or legal injunctions are not transgressed.

E. Some Myths and Misperceptions

A number of common myths and misconceptions should be dispelled. Venture capital is not only designed to finance technological breakthroughs in high technology sectors such as biotechnology, semiconductors, or the Internet. It is also used, even in Silicon Valley, to finance light industry, energy projects, health care, and a wide array of services. In Europe, to this day, the greatest part of venture capital funds is invested outside high technology.[xxx]

Nor did venture capital emerge spontaneously or "fully formed" in Northern California. After all, transparent and efficient markets are not natural but man-made. It took considerable travails before venture capital came of age. The "libertarian" rhetoric of many venture capitalists notwithstanding, government policies played a major role in propelling, if not in shaping, the industry. The lowering of capital gains taxes in 1978 spurred the creation of new businesses. The 1980 U.S. Supreme Court decision that man-made organisms could be patented marked the birth of the biotechnology industry.[xxxi] As for the Internet—in the late 1990s the sector of predilection for venture capital—it started as a defense-related project.

IV. Recent Islamic Experiences in Profit-and-loss Sharing Revisited

Shortly after Islamic finance came into existence in the 1970s, Islamic institutions plunged with great enthusiasm (and virtually no experience) into *muḏāraba* and *mushāraka*. The result was, to say the least, disappointing, and most institutions have since increasingly steered clear from partnership finance.

Islamic bankers clearly underestimated the difficulties of partnership finance. The literature did enumerate the proper rules and practices: bankers were expected to exert due diligence; all operations had to be transparent; the *muḏārib* had to prove that he was reputable and experienced, and that he enjoyed high moral standing within the business community; the project had to be viable and assessed independently by the bank or by external consultants; and the bank had to ensure that its funds were properly spent and that the venture being financed was properly monitored.[xxxii] But these precepts were vague and abstract. Little attention was paid to the banks' lack of experience and to the institutional vacuum within which they were operating. Perhaps most importantly, there was the implicit assumption that all participants in the process were competent as well as honest. This section considers the mistakes made and suggests ways of correcting them.

A. Lack of Experience and Appropriate Skills

Since the early days, Islamic banks have suffered from a lack of experienced and qualified personnel. Bank officers had to possess at once management skills appropriate to a conventional institution and religious training. It was probably too much to ask also for skills in partnership finance, since such skills were not anywhere in existence. In other words, even otherwise competent bankers proved ill suited to partnership finance:[xxxiii] trained for the most part at conventional institutions, they were bound to bring with them the mindsets and the attitudes of conventional banks. Yet as noted earlier, partnership finance is fundamentally different from conventional lending. In the words of John Wilson, "(t)o do well in venture capital, banks must train and retain a cadre of specialists who differ markedly in background, skills, and temperament from most of their employees."[xxxiv]

Partnership finance requires a wide range of experience and skills. Its practitioners must know how to ferret out deals, how to value, negotiate, and structure investments, and how to supervise investments without stifling them. They must combine the skills of the banker (in assessing business risk and the likelihood of repayment) and the creativity of the entrepreneur (in sizing up and seizing opportunities). A recent survey of Islamic PLS highlights typical blunders: the inability to critically assess business plans (the tendency not to question assumptions or rosy "hockey stick" projections of sales and revenues); the tendency to approve most projects submitted, without an independent assessment of their market potential, of the competition and of the caliber of the people involved; the propensity to "follow the crowd" and go for "me-too" financings; and the preference for well-connected businesspeople rather than for truly creative entrepreneurs.[xxxv]

Partnership finance is as much science as it is art. Conventional bankers are often not temperamentally suited to the uncertain and complex world of partnership finance. For example, pricing a venture deal—that is, setting a value for a company that has no products, no assets, and decidedly no profits—is an arcane process that does not lend itself to standard formulas. The practitioners of partnership finance must have a keen understanding of business and economic cycles. They must at all times question the conventional wisdom. They are constantly engaged in a balancing act: between caution and recklessness, between ignoring red flags and danger signs and overreacting to difficulties, between giving up too soon and not knowing when to cut their losses, between guiding new businesses and stifling them.

B. Institutions and Cultures

Beyond internal resources, banks suffered from the lack of a proper institutional and cultural environment. Necessary institutions include standard accounting and financial reporting norms and enforceable commercial rules and regulations concerning rights and obligations, contracts, bankruptcy, etc. More elusive are cultural factors, which are themselves influenced by institutions and history. The attitude toward risk is a case in point. The image of businessmen as entrepreneurs as described by Joseph Schumpeter or George Gilder, who thrive on risk and creative destruction, does not quite fit much of the contemporary Islamic context.[xxxvi] Even within supposedly entrepreneurial environments, rent seeking is the norm. Consider, for example, this description of the typical Egyptian businessman:

> "A Cairene entrepreneur, even one who faces no serious competition, still has to cope with unpredictable changes in inflation, vacillating exchange rates, and capricious government policies. The country lacks genuine capital markets, so the odds are that the entrepreneur's capital represents the sum of his family resources, either saved over long years or inherited from some glorious ancestor. One of the reasons that rent

> seeking is such a popular technique among businessmen is that it holds risk to a minimum. It is a way of getting the government to guarantee against the risks of certain ventures. As a result, Egyptian businessmen are not unimaginative, but they are justifiably cautious."[xxxvii]

Under such circumstances, risk avoidance is a perfectly rational behavior. Long-term investment requires a culture and institutions that are predictable and foster trust.[xxxviii] In order to take a calculated risk, the entrepreneur will expect political and economic stability in his environment, and consistency in the enforcement of the law. In much of the Islamic world, people still have memories of expropriation and arbitrary decisions by governments that have adversely affected their business ventures.[xxxix] Rampant inflation also discourages long-term investment, and so do currency fluctuations, which can wipe out savings overnight.[xl]

Another factor is that the worlds of business and finance are likely to be politicized and embedded within social institutions (family, tribe, ethnic, or religious group). "Connected lending" (lending to entities otherwise related to the financial institutions) tends to be very high, and when loans go bad, custom and social mores prevent the use of modern enforcement techniques (foreclosures, forced bankruptcies, etc.). The protection of the law is not always assured, and the Islamic moral hazard (defined in the following section) is likely to make things worse. In many countries, delaying payment is a common practice, and defaulting borrowers—provided that they are well connected—can be beyond the reach of the law.[xli]

C. The Islamic Moral Hazard

The notion of moral hazard is commonly used in connection with financial regulation. It refers to policies that may encourage reckless behavior.[xlii] By the same token, one could identify an "Islamic moral hazard" in that certain features of Islamic finance can encourage unscrupulous behavior. In the words of Hamid Algabid: "At the beginning, confidence was the rule. The good faith of the participants could not be questioned since it was identified with religious faith. Since spiritual and temporal matters could not be dissociated, a pious man could only act in good faith. Experience has since shown that banking operations could not be based on that assumption, and particularly that guarantees could not be limited to the affirmation of one's Islamic faith."[xliii] Indeed, in the early years, it was axiomatic that all people involved in Islamic finance—bank employees, clients, etc.—were people of virtue, who acted at all times in a righteous manner. Bank executives acknowledged that they had trusted people who did not deserve their trust.[xliv] The chief executive of the (now-defunct) London branch of the Dallah Albaraka group explained why his bank was not involved in profit-and-loss sharing (PLS) operations: "The depositors wanted an Islamic deal without risk. They liked, at least, to guarantee their capital. The problem with PLS is that [the Islamic economists] assume the scenario of the entrepreneur being a good Muslim."[xlv]

A subtler but equally pervasive form of Islamic moral hazard is the advantage that can be taken from ambiguity. Unlike secular systems, the legal system of Islam incorporates both an economic and a religious logic. As Noel Coulson noted: "Commercial law (...) in the West is orientated toward the intrinsic needs of sound economics, such as stability of obligation and certitude of promised performance. In the religious law of Islam, on the other hand, equitable considerations of the individual conscience in matters of profit and loss override the technicalities of commercial dealings. It is the harmonization of these two very different approaches which poses the real challenge for developing Islamic law today."[xlvi] In the absence of a clear regulatory and legal framework, such ambiguity has allowed borrowers to escape their obligations with impunity.

D. Exit Strategies

The main "exit strategy" anticipated by Islamic PLS was based on progressive disengagement from a successful concern: the share of the financial institution would progressively diminish in favor of the entrepreneur. Funds would thus be freed up and invested into new ventures, while the entrepreneur would increase his control over his business. Hence the variations on *muḏāraba* and *mushāraka* respectively called the "diminishing" *muḏāraba* (*muḏāraba mutanāqiṯa*) and the "diminishing" *mushāraka* (*mushāraka mutanāqiṯa*). In both cases, the bank's share is progressively reimbursed, allowing the entrepreneur progressively to increase his share in the project.

In the literature on Islamic finance, few provisions were made for a venture's failure. The assumption was that all projects would be successful—with the corollary that the financier had a moral obligation to keep on subsidizing a money-losing operation. In contrast, venture capitalists assume that most companies will fail to fulfill their potential and fold. When they conclude that a project is not viable, they cut their losses by refusing further injections of money. It is a logic based on the view that the business world is one where the "gales of creative destruction" make sure that the success of the few is counterbalanced by the failure of the many. Although the ideal exit strategy for a venture capitalist is through an initial public offering (IPO), or a merger or acquisition, most exits occur when the venture capitalist "pulls the plug" on an investment. The lack of a properly functioning liquidation system combined with the proliferation of "connected lending" makes it difficult for banks to "just say no" to entrepreneurs seeking more financing.

E. Business Cycles and the Boomtown Mindset

Modern Islamic banking coincided with the oil boom of the mid-1970s.[xlvii] It was a time of euphoria in much of the Islamic world (especially among oil-producing countries) with high hopes of more equitable North-South relations—the so-called New International Economic Order (NIEO)—and a prosperous regional economy. There was a widespread belief that new trends were here to stay: business plans extrapolated from the most optimistic assumptions. As a result, most projects presented for funding were approved. But the price of oil peaked in 1981 and much of the Islamic world experienced recession for much of the 1980s.[xlviii] The oil-related euphoria had masked the vagaries of the business cycle. Too much money was chasing too few good opportunities. Get-rich-quick mindsets clouded the judgments of financiers as well as entrepreneurs. By the time banks had rediscovered time-honored truths—economies go through cycles of boom and bust, growth and recession; more businesses fail than succeed—they had already soured on profit-and-loss sharing.

V. The Organizational, Cultural, and Strategic Challenges of Partnership Finance

This section considers lessons based on the experience of American venture capital firms that could be usefully applied to the revitalization of Islamic finance. It discusses the role of a partnership finance unit within a bank, the mechanics of venture capital financing, culture and mindsets, and the strategic dilemmas of partnership finance.

A. Banks and Venture Capital

Increasingly, for reasons already explored, banks and other financial institutions are involved in venture capital. This raises organizational and strategic questions: How to integrate partnership finance within a broadly based financial institution? And how to reconcile the logic of risk-taking with the fiduciary responsibility of a deposit-taking institution? In answering such questions, the experience and strategic choices of American banks active in partnership finance is useful.

The involvement of commercial banks in venture capital has taken different forms. Certain institutions, such as the Silicon Valley Bank or Comerica Bank, cater principally to the entrepreneurial and venture capital communities. Most large American banks—particularly San Francisco-based Bank of America—have been active in venture capital, directly or through dedicated subsidiaries, since the 1960s.[xlix] Understandably, most initial forays were marked by failure. Despite ups and downs, some of these banks have become quite skilled in partnership finance. In the late 1970s and 1980s, the larger banks experienced returns exceeding 30% from their Silicon Valley venture funds.[l] In 1997 and 1998, some of the most successful funds achieved returns of 80%.[li] Because of existing laws and regulations—in particular the Glass-Steagall Act, which as of this writing seems likely to be abolished—limiting direct involvement by commercial banks in other areas of finance, banks could act as venture capitalists only through dedicated subsidiaries.[lii]

The forced autonomy of venture capitalist subsidiaries proved a blessing, since it insulated venture capitalists from the meddling of conventional bankers. Insofar as the logic and principles of venture capital differ sharply from those of classical banking, successful banks have learned to understand those differences and address the strategic challenges of entrepreneurial banking. From a bank's standpoint, the attractions of venture capital are many. In addition to the intrinsic profitability of venture capital funds, banks can, in an environment of deregulated finance, conduct a wide range of transactions—ranging from loans to initial public offerings (IPOs)—with the new and promising companies they fund.

From the above, we can infer the preliminaries to the involvement of financial institutions—Islamic or otherwise—in partnership finance. They must:

1. create semi-autonomous PLS units staffed by people with special skills, whose career paths and compensation are not necessarily comparable to other bank employees;
2. give substantial decisional autonomy to those units, in particular avoiding interference by top executives;
3. decide on a share of the bank's assets that should be dedicated to PLS, and devise funding strategies accordingly.

B. Venture Capital Mechanisms

There are different stages in the venture capital process. Each has its own financial and economic characteristics. "Seed money" refers to the funding of the nucleus of a company. Often it is designed to simply move on beyond the idea stage. At the other extreme is the "exit," which marks the end of the venture capital process. Exit occurs when the company goes public (for instance through an IPO), merges with or is acquired by another company, or folds.

There are a number of stages in financing, from "early stages" that allow the company to start functioning, to "expansion stage" financing that provides the company with resources to grow beyond critical mass. "First-round financing" truly establishes the company, giving it the resources to fulfill its potential. Mezzanine financing refers to "in-between" financing for a company with IPO prospects. There can be many more rounds of financing before that stage. Understanding the characteristics of those stages is crucial.[liii]

At all times, there must be clear awareness of the odds. In a typical venture capitalist's portfolio, there are a few huge successes, a number of modest winners—and a majority of money-losers. From the standpoint of the entrepreneur, seeking money is nonetheless brutal: in Silicon Valley, the typical venture capitalist looks at about 400 prospects a year, studies closely about two or three dozen, and ends up investing in possibly three or four.[liv] As the next section shows, the mindsets of venture capitalists reflect this reality.

C. Mindsets

Silicon Valley venture capitalists have an idiosyncratic culture.[lv] Perhaps the best illustration is the prevalent attitude toward failure. Paradoxically, given the pervasive glorification of success, failure does not, as it does in other cultures, carry a stigma.[lvi] It is viewed as a learning experience—an indication that past mistakes are less likely to be repeated. Thus, having failed at a previous venture is not necessarily disqualifying for future financing. Michael Lewis wrote:

> "(t)he Valley has responded (to frequent failures) by making failure something of a badge of honor. In the past 20 years or so, it has created the closest thing in capitalism to the old aristocratic idea of the nobility of failure. Get any prominent Silicon Valley person talking about what makes his culture special, and sooner or later he will say something like this: 'We have built a new system. Unlike you people back East, we do not stigmatize people as failures. Here we understand that failure is what happens when you try. We reward it.' By this he does not mean that people get rich by failing—though they do sometimes make a lot of money by selling to the overheated public stock in companies that will never turn a profit. He means that an entrepreneur who has gone broke three times in a row can, if he has a fourth good idea, find people who will back him."[lvii]

D. Involvement in Management

One of the basic rules of traditional Islamic PLS is a clear separation of roles: the *rabb al-māl* provides the funds; the *muḏārib* manages the venture; and at the end of the process, the accounts are settled. Such an arrangement made sense in the old days, when financing typically involved trade ventures involving distant travel. In today's environment, there is no reason why the roles should be so clear-cut. Indeed, success comes from a creative partnership in which the investor's lengthy and often painful experience in the company formation process is combined with the entrepreneur's management skills and detailed knowledge of a market or technology.[lviii]

Unlike conventional lenders, venture capitalists foster growth in companies they fund through their occasional involvement in strategic decisions (although a good venture capitalist also knows the stifling effect of too much involvement in a company's operations). Typically, the partner who arranges an investment in a company will take a seat on that company's board of directors and, for the next several years, play an active role in guiding the company. Some venture firms are also successful by creating synergies between the various companies in which they have invested. For example, a company with a good software product but no adequate distribution may be paired with another company or its management in the venture portfolio that has better distribution technology.

E. Between Diversification and Specialization

Venture capital funds come in all shapes and forms. Some are specialized by industry, region, or type of financing, whereas others are diversified. Indeed, there are two seemingly contradictory imperatives to partnership finance: there must be diversification (for hedging purposes) as well as specialization (as a way of building expertise in specific areas, industries, financing rounds, etc.). There is an actuarial logic to such investing—mitigating the risk of venture investing by developing a portfolio of reasonably diverse investments, and tailoring specific funds to the risk appetites of investors. The most diversified approach occurs when a financier invests in a "fund of funds," a partnership organized to invest in other partnerships, thus providing the limited partner investor with added diversification and the ability to invest smaller amounts in a variety of funds.

But at the same time, venture capitalists must be specialists, building expertise and taking advantage of synergies within a specific region, sector, or type of financing (seed financing, first-round financing, expansion stage financing, turnaround situations, etc.).

VI. Building Networks of Partnership Finance

Partnership finance cannot be consistently successful unless broad networks are created, linking PLS practitioners with one another, with other professionals, and with the community at large.[lix] Such networks are especially important if a secondary market in *muḏāraba* certificates is to be developed. Despite the mythology of the individualistic entrepreneur unable to thrive within a structured environment, venture capital works best within "networks" or a "community." The storied Sand Hill Road in Menlo Park, California, on the northern edge of Silicon Valley, provides an example of a cluster of firms benefiting from being situated in the same geographic area. It is also revealing that Kleiner Perkins Caufield & Byers, the most famous venture capital firm of all, speaks of its *keiretsu*, by analogy with Japanese "families" of companies.

This section focuses on related activities that can facilitate the partnership finance process. Islamic financial institutions should strive to create and position themselves at the center of such networks. Here again the Silicon Valley experience is invaluable. Networks include "angels," "incubators," "venture catalysts," and other elements designed to foster appropriate institutions and subcultures, instill new attitudes, devise common standards (in financial reporting for example), and impose the necessary controls and discipline on borrowers. In addition, Islamic institutions should use their clout to lobby governments to promote an environment favorable to PLS.

A. Angels

The recent stock market boom has led to the emergence of a new sub-category of venture capitalists, the "angels," so-called because of their almost providential role. Indeed, what sets angels apart from typical venture capitalists is that they invest in companies that the typical venture capitalist would not touch. Angel investors may either be wealthy people with management expertise, or retired businesspeople who seek the opportunity for first-hand business development. The angels' occasional and often informal investments are usually in fields related to their background. They mentor a company and provide needed capital and expertise to help develop it—which in due course may result in attracting other financiers.

B. Incubators

Business incubators provide start-up business owners with low cost office space, advice, and other types of managerial and technical assistance. Their purpose is to shelter inventors and entrepreneurs whose ideas hold promise but are too fragile to survive in the free market. Big companies like Xerox as well as a number of venture-capital firms have their own incubators. And increasingly, government agencies, at both the national and local levels, are promoting them as tools of business development and economic growth. One of the best known Silicon Valley incubators is that of the National Aeronautics and Space Administration (NASA), which attempts to help promote technologies spun out of the space agency. As in the case of angel-supported projects, being part of an incubator confers credibility. Often, lawyers, accountants, and other professionals line up to offer their services in exchange for a tiny piece of a new company.

C. Venture Catalysts

Venture catalysts help entrepreneurs navigate the venture capitalism maze. In the early stages, they help write, rewrite, and "package" the business plan, and provide assistance in honing the "pitch" entrepreneurs make to professional investors. In later stages, they can perform various forms of "hand-holding," ranging from strategic advice to the recruitment of a board of directors. They are often compensated with shares of the company.[lx]

D. The Role of Islamic Financial Institutions

Given their positions in their respective societies, Islamic financial institutions have a crucial leadership role to play in building such networks and influencing public policy. Indeed, entrepreneurial networks cannot thrive unless the political system sets rules of play and enforces them. In much of the Islamic world, "individuals and enterprises are at the mercy of administrative interpretations and applications, and can only succeed through the informal facilitation and evasions of bureaucratic functionaries."[lxi] Islamic banks must use their political clout to achieve a number of public policy goals, chief among them consistency and coherence in a number of areas, ranging from uniform accounting and financial reporting rules to a comprehensive legal system that addresses issues such as bankruptcy and directors' liability.

VII. Adapting Venture Capital Practices to the Islamic World

The American venture capital environment could not, and should not, be transposed as is to the Islamic world. For one thing, there are major institutional and cultural obstacles to such a transposition. More importantly, features that have proven successful—and that may be legal—may be ethically dubious. Many features of venture capital should be tempered with the moral values of Islam, especially as they pertain to *gharar* and *ribā*.

The injunctions against *gharar* (usually translated by the trilogy "uncertainty, risk, speculation") are not injunctions against risk per se, but against taking advantage of uncertainty and risk. *Gharar* has also been interpreted as speculation that brings no economic benefit, or transactions driven solely by financial engineering. And it is prohibited by analogy with the prohibition of gambling or of any scheme where the allocation of rewards is random, and where people get something for nothing.[lxii] The general argument is congruent with the moral economy of Islam as well as with the PLS logic: wealth should come from industriousness as well as risk-sharing, which is why Islam is firmly against selling and otherwise transferring risk to third parties, without assuming a share of the risk.

Ribā is commonly translated as usury or interest. While partnership finance bypasses the interest-rate problem, *ribā* (literally meaning increase) in its broader sense—the equivalency of counterparts—may still pose a problem as venture capital is fraught with conflicts of interest, and it is relatively easy to take advantage of one party's lack of knowledge (*jahl*) or weak bargaining position.[lxiii] The *muḏārib* can ask for more money than he needs, or he can engage in high-risk endeavors, knowing that he is not be committing his own money. A bank can also take advantage of a *muḏārib* who is pressed for cash to snare a bigger share of a venture. It can also structure the transaction so as to "privatize profits and socialize losses," i.e., reserving for itself the lucrative parts of a deal, while transferring the least profitable ones to the passive investors (the bank depositors).[lxiv]

VIII. Conclusion: From Vicious to Virtuous Circle

This paper argued that the revitalization of Islamic partnership finance is long overdue, and that rather than "reinventing the wheel" through a lengthy trial-and-error process, Islamic financial institutions should draw on the experience of American-style venture capitalism. It would be easy to adopt a fatalistic attitude, arguing that cultures and institutions in the Islamic world are ill adapted to partnership finance, or to find it incongruous to associate Silicon Valley and Islamic business practices. To be sure, culture cannot be changed overnight, but subcultures and appropriate institutions can be created. The example of micro-lending is in that respect revealing: small-scale entrepreneurial networks were established in the most unlikely areas by devising appropriate institutions and incentives.[lxv] Most importantly, as we saw, the logic of Islamic PLS and that of Western-style venture capitalism are identical. Properly understood, most principles and strategies are transposable, albeit with appropriate modifications, to an Islamic environment. The global economy will no doubt impose pressures on Islamic financial institutions to reconsider their neglect of Islamic finance. The lessons from Western venture capital will at the very least shorten the learning curve.

In justifying the weakness of Islamic PLS, there is a lot of blame to go around banks, governments, depositors, and entrepreneurs who did not play their assigned roles. It became a vicious circle: if failure was likely, there was ample reason for all involved to shun partnership finance. This vicious circle should be transformed into a virtuous one. By adopting the proper strategies, banks can become successful at partnership finance. This in turn will encourage depositors and improve the attitudes of entrepreneurs. Only a consistent track record can inspire the necessary public confidence. Banks must work on many fronts: they must understand why early experiments failed and why venture capitalism has succeeded elsewhere; they must devise proper strategies, procedures and mechanisms; they must work at creating networks and lobbying public officials. Perhaps the greatest challenge is to instill a culture fostering the development of profit-and-loss sharing.

[i] Partnership finance, profit-and-loss sharing (PLS) venture capitalism, and commenda partnerships are all synonymous. For clarity purposes, in this paper, partnership finance will be used as a generic term, profit-and-loss sharing (PLS) will refer to the Islamic practices of *muḏāraba* and *mushāraka,* venture capitalism will refer to partnership finance outside the Islamic world (principally in the United States), and commenda partnership will refer to a corporate structure (allowed in certain countries such as France) based on profit-and-loss sharing between a financier and an entrepreneur.

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[iii] Al Mausua al Ilmiya wa al Ammaliya lil Bunuk al Islamiya (The Handbook of Islamic Banking). Cairo: International Association of Islamic Banks, 1977-1986.

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[vi] Mallat, Chibli. Islamic Law and Finance. London: Graham and Trotman, 1988.

[vii] Noonan, John. The Scholastic Analysis of Usury. Cambridge: Harvard University Press, 1957; Benoit, J. Pierre V. United States Interest Rates and the Interest Rate Dilemma for the Developing World. Quorum Books, 1986. pp. 34-55; and Warde, Ibrahim. Islamic Finance in the Global Economy. Edinburgh: Edinburgh University Press, 1999. (See especially Chapter 3, "*Ribā*, *Gharar* and the Moral Economy of Islam in Historical and Comparative Perspective.")

[viii] Al-Harran, Saad. Ed. Leading Issues in Islamic Banking and Finance. Selangor: Pelanduk Publications, 1995. p. xi.

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[xiv] Chaudhry, Kiren Aziz. The Price of Wealth: Economies and Institutions in the Middle East. Cornell University Press, 1997. p. 2.

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[xvii] The World Bank. World Development Report 1991: The Challenge of Development. Oxford University Press, 1991.

[xviii] Sadowski, Yahya M. Political Vegetables? Businessman and Bureaucrat in the Development of Egyptian Agriculture. Washington: The Brookings Institution, 1991. p. 100-102.

[xix] The Wall Street Journal. June 19, 1997.

[xx] The most famous example in the Islamic world is Malaysia's Multimedia corridor. But there are countless other examples. See The Daily Star. July 7, 1999.

[xxi] Harik, Iliya and Denis J. Sullivan. Eds. Privatization and Liberalization in the Middle East. Bloomington: Indiana University Press, 1992.

[xxii] Khan, Shahrukh Rafi. Profit-and-loss Sharing: An Islamic Experiment in Finance and Banking. Karachi: Oxford University Press, 1988.

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[xxiv] Wilson, John W. The New Venturers: Inside the High-Stakes World of Venture Capital. Reading: Addison-Wesley, 1985. p. 5.

[xxv] Vogel and Hayes. p. 130.

[xxvi] Khan, Shahrukh Rafi. Profit-and-loss Sharing: An Islamic Experiment in Finance and Banking. Karachi: Oxford University Press, 1988.

[xxvii] The American venture capital boom can be captured by the following statistics of the National Venture Capital Association:

- dollars raised by venture capitalists from institutional investors: $25.3 billion (1998), $15.2 billion (1997), $10.5 billion (1996).

- dollars venture capitalists disbursed to companies: $16.7 billion (1998), $13.6 billion (1997), $9.9 billion (1996).

[xxviii] Warde. Islamic Finance in the Global Economy. Chapter 7.

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[xxx] Warde. "Venture Capital and Partnership Finance."

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[xxxiv] Wilson. The New Venturers. p. 159.

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[xlii] Warde. Islamic Finance in the Global Economy. Chapter 10.

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[xlv] Al-Omar, Fuad and Mohammed Abdel-Haq. Islamic Banking: Theory, Practice and Challenges. London: Zed Books, 1996. p. 43

[xlvi] Preface to Saleh, Nabil. Unlawful Gains and Legitimate Profit in Islamic Law. Cambridge: Cambridge University Press, 1986.

[xlvii] For a historical overview, see Warde. "Venture Capital and Partnership Finance."

[xlviii] On the expectations bred by bullish markets, see Galbraith, John Kenneth. A Short History of Financial Euphoria. New York: Viking, 1990.

[xlix] The initial vehicle was the Small Business Investment Corporations (SBICs). See Wilson. The New Venturers. p. 157.

[l] Wilson. The New Venturers. p. 158.

[li] Warde, Ibrahim. "Banks and Venture Capital." IBPC Working Papers. San Francisco: IBPC, 1999.

[lii] The Federal Reserve regulates Bank Holding Companies (BHCs) and their subsidiaries, and limits the percentage of a bank's capital that can be dedicated to such activities. See Warde, Ibrahim. "The Regulation of Foreign Banking in the U.S." IBPC Working Papers. San Francisco: IBPC, 1999.

[liii] Gladstone. Venture Capital Handbook.

[liv] Warde. "Venture Capital and Partnership Finance."

[lv] See Bronson, Po. The Nudist on the Late Shift: And Other Tales of Silicon Valley. New York: Random House, 1999; and Kaplan, David A. The Silicon Boys and Their Valley of Dreams. New York: William Morrow, 1999.

[lvi] Vallée, Jacques. Les enjeux du millénaire: Capital-risque et innovation. Paris: Hachette Littérature, 1998. p. 58.

[lvii] Lewis, Michael. "Losers: The Cult of Failure in Silicon Valley." Slate (January 24 1998).

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[lx] The Wall Street Journal, February 26, 1999.

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[lxii] Warde. Islamic Finance in the Global Economy. Chapter 3.

[lxiii] Saleh. Unlawful Gain. p. 34.

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