

Some aspects of small business financing through profit and loss sharing model in Islamic economic doctrine

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Abstract

There have been at least two distinctive approaches to try to overcome the SME finance gap. The first has been to broaden the collateral based approach by encouraging bank lenders to finance SMEs with insufficient collateral. This might be done through an external party providing the collateral or guarantees required. The second approach has been to broaden the viability based approach. Since the viability based approach is concerned with the business itself, the aim has been to provide better general business development assistance to reduce risk and increase returns. These two approaches in overcoming the SME finance gap are implemented and consistent with Profit and Loss Sharing Model, also called PLS or “participatory” banking. Profit and Loss Sharing is a method of finance used by Islamic financial or Shariah-complaint institutions to comply with the religious prohibition on interest on loans that many Muslims subscribe to.

Keywords: small business financing, under capitalization, Profit and Loss Sharing Model, SME finance gap, Islamic finance.

1 Introduction

There have been at least two approaches to try to overcome the SME finance gap.

The first has been to broaden the collateral based approach by encouraging bank lenders to finance SMEs with insufficient collateral. This might be done through an external party providing the collateral or guarantees required. Unfortunately, such schemes are counter to basic free market principles, and they tend to be unsustainable. This sector is increasingly called the Meso-finance sector.

However, there are some significant structural barriers for bank or private equity to finance suitable SME applicants on mutually satisfactory terms and conditions. The main obstacles to funding are:

- lack of satisfactory business plans and reliable expertise, accounting and other information;
- inadequate assets for use as security;
- insufficiently high levels of profitability, gearing, liquidity, stability, and other business-financial performance criteria on the part of funding applicants.

The second approach has been to broaden the viability based approach. Since the viability based approach is concerned with the business itself, the aim has been to provide better general business development assistance to reduce risk and increase returns. This often entails a detailed review and assistance with the business plan. A common aim or feature of the viability based approach is the provision of appropriate finance that is tailored to the cash flows of the SME.

These two approaches in overcoming the SME finance gap are implemented and consistent with *Profit and Loss Sharing Model*, also called *PLS* or “participatory” banking. Profit and Loss Sharing is a method of finance used by Islamic financial or Shariah-complaint institutions to

comply with the religious prohibition on interest on loans that many Muslims subscribe to.

The jurisprudence used to engineer Sharia-based financial contracts is rather complex. Scholars must complete several years of training before becoming certified to issue financial rulings. However, there is no centralized Sharia finance authority, and consequently, there can be conflicting views on the implementation of these principles in designing and extending Islamic financial products. Many sources state there are two main schemes for profit and loss sharing model used by Islamic banks – *Musharakah* (equity participation contract) and *Mudarabah* (trustee finance contract or passive partnership). Other sources include *Sukuk* (also called “Islamic bonds”) and direct equity investment as types of PLS.

Both PLS schemes require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed justly. So these two types of contracts within Profit and Loss Sharing Model are used to overcome the SME finance gap and to finance small businesses in Islamic economic doctrine.

2 Conclusion

Profit and Loss Sharing has been called “the main justification” or even “the very purpose” of the Islamic finance and banking movement and the “basic and foremost characteristic of Islamic financing” [1].

Despite of having obvious positive aspects, such as focusing on financing the real sector of economy and encouraging direct interrelationship between financial and productive sectors, in our view, the mechanism of PLS in some ways is at variance with a number of fundamental principles of effective economic activity.

Critics have in turn criticized PLS advocates for

remaining “oblivious to the fact” that the reason PLS has not been widely adopted “lies in its inefficiency” (Muhammad Akram Khan) [2] and their “consequence-insensitive” way of thinking, assuming that “ample supply” of PLS “instruments will create their own demand” (Nawab Haider Naqvi), consumer disinterest notwithstanding [3].

Because clients can share losses with banks in a PLS financing, they (the clients) have less financial incentive to avoid losses of risky projects and inefficiency, than they would with conventional or debt-based lending. Moreover regarding the rate of profit and loss sharing – i.e. the “agreed upon percentage of the profits (or deduction of losses)” the Islamic bank takes from the client – there is no market to set it or government regulation of it. This leaves open the possibility the bank could exploit the client with excessive rates.

In conventional banking, the banks are able to put all their assets to use and optimize their earnings by borrowing and investing for any length of time including short periods such as a day or so. The rate of interest can be calculated for any period

of time. However, the length of time it takes to determine a profit or loss may not be nearly as flexible, and banks may not be able to use PLS for short term investment [4].

PLS is also not suitable or feasible for non-profit projects that need working capital, (in fields like education and health care), since they earn no profit to share. So today PLS schemes to finance small business originally operate in an unclear regulatory landscape. However, as they expanded, they presented several regulatory challenges that governments have attempted to address to various degrees. With increased attention by regulatory authorities, international organizations also have been created to set Islamic finance accounting and other standards.

Despite a shared core of Islamic values, these institutions often diverge with national regulators (and each other) over Sharia standards and crucially require further unification and standardization to be effective and convenient in small business financing.

References

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