# Fixed Payment Partnership Instrument: A solution towards convergence of practicality and morality

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**January 2016**

***Keywords: Islamic Finance, Musharaka, Partnership***

**Extended Abstract**

What makes conventional financial products extensively accepted despite their moral drawbacks? This is a primary question that often Islamic finance scholars face. In this paper we aim to show that the favorable advantages of the conventional bonds/ loans are related to some other features than usury or riba. Fixed income securities are devised to address specific risks: liquidity risk and profitability risk. Covering both risks are alluring to investors; however, liquidity risk is the main concern. In Islam and other Abrahamic religions usury or riba is prohibited. Fixation of interest payments is the cause for the ban on various conventional products by Islamic scholars. We attempt to set an example by providing a financial product that covers liquidity risk, thus appealing to majority of investors, still accepted in Islamic Jurisprudence due to its profit and loss sharing (PLS) structure.

Nowadays, a majority of the existing Islamic products rooted in conventional banking counterparts, which are trimmed to be Sharia compliant. While most of contemporary Islamic products are the reversed engineered versions of their conventional counterparts, Islamic scholars long for solutions compliant with both the letters of the law and the spirit of the law of Islamic finance.

Partnership (*Musharaka*) is known as a fundamental idea of ethical finance. This mode of finance gives flexibility to financial structure; thus a company fully funded through equity would be free from bankruptcy. Nonetheless, partnership is not a panacea suitable for every situation. While cash flows are uncertain in partnership, providers and/or users of funds might prefer relatively certain and predictable cash flows. Fixed

income securities promise stable cash flows; however, they raise the possibility of default, imposing additional expenses to businesses. When a firm approaches bankruptcy, cost of funds skyrockets and access to new sources of funds gets cumbersome. As a result lenders acquire ultimate power to dictate their own terms and conditions. This is the root of usury.

Our initiative, Fixed Payment Partnership Instrument (FPPI) is a relatively sophisticated financial solution which attains a number of financial and legal advantages over the existing fixed-income securities. The idea is established by combining two building blocks of Islamic products — partnership (*Musharaka*) and interest-free lending (*Qard al hassan*) — therefore is fully Sharia-compliant. Equitable distribution between the two parties is the main principle in designing this instrument.

FPPI's breakthrough in the theory of Islamic/ethical finance is the distinction between ownership/wealth distribution and cash payments. Proceeds of an investment can be assigned based on a partnership contract and still a stable cash flow mechanism can be achieved. This hybrid instrument combines partnership with a series of reverse *Qard al hassan* loan contracts. Investors invest in the enterprise through a partnership contract. Profits of the venture is measured annually and accumulated in an account, dubbed as "*FPPI's deferred earnings account*" (DEA). For cash flow needs of the investors certain amounts of cash are periodically distributed to the investors. These *Qard al hassan* loans are accumulated as the investor's liability in a "*loan account*." At maturity, total return to investment is calculated and investors settle their *Qard al hassan* before receiving the final payment.

To insure financial viability and equitable distribution, three more initiatives are devised: (1) Top-up of the DEA, (2) adjustment of partnership ratio, and (3) assignment of voting rights.

Furthermore, the main argument in favor of conventional banking is the "time value of money." Lender sacrifices cash flow now, thus expects to be compensated for the

delay in returning the fund. This reasoning is void in FPPI. Investor sacrifices a lump sum at the beginning of the contract; enterprise sacrifices cash flows as *Qard al Hassan* over the tenor of the contract. Both parties are equality treated; therefore no justification for riba.

FPPI is a bundle of different creative ideas, of which compensating defaults with higher shares in profit is quite original. Adjustment of partnership ratio can eradicate the justification for compound interest rates. The primary rule of financial viability calls for discouraging of defaults; otherwise, moral hazard comes into effect and default rates rise steeply. The chief response of conventional banks to higher default rates is higher compound interest rates. Based on compounding convention, indebtedness increases exponentially. Any default should be addressed immediately otherwise it becomes unmanageable. It is evident that compound interest rate is an overreaction to the issue of temporary default.

Our response is fair and ethically acceptable: default is legally permitted but financially discouraged. The maximum possible penalty for severe financial distress with several defaults is limited to taking over the entire (100%) accumulated profit (DEA), compared to compounding convention which is an unlimited punishment.

FPPI distributes profits at the maturity. This long-term strategy discourages short-term manipulation of financial statements by the management (window dressing). Consequently, financial reports are more reliable. Also the long-term approach of FPPI encourages management to take on long term profitable projects. This removes moral hazard and enhances profitability in the long run.

Furthermore, FPPI reduce the serious "agency problem." Corporations often partially distribute dividends and keep the remainder as "retained earnings." This accumulated profit remains in hand of the management forever. In contrast, DEA has a maturity, when all the deferred earnings should be distributed based on the predetermined partnership ratio.

# 1. INTRODUCTION

This initiative, Fixed Payment Partnership Instrument (FPPI) is a relatively sophisticated financial solution which attains a number of financial and legal advantages over the existing fixed-income securities. The idea is established by combining two building blocks of Islamic products — partnership (*Musharaka*) and interest-free lending (*Qard al hassan*) — therefore is fully Sharia-compliant. Equitable distribution between two parties is the main principle in designing this instrument.

What makes conventional fixed income securities extensively accepted despite their drawbacks? This is a primary question that often Islamic finance scholars face. Based on our research, the favorable advantages of the conventional bonds are related to some other features than usury or riba.[1] Fixed income securities cover two specific risks, liquidity and profitability. Covering both risks are alluring to investors; however, liquidity risk is the main concern for investors. On the other hand, Islam and other Abrahamic religions prohibit usury or riba. Thus covering profitability risk is the chief cause for the ban on various conventional products by Islamic scholars. Here, we attempt to provide a financial product that covers liquidity risk, thus appealing to majority of investors, still accepted in Islamic Jurisprudence because it is build based on profit and loss sharing (PLS).

Through a couple of innovative ideas, FPPI addresses the demanded features without compromising on the forbidden areas. Some of the initiatives are as follows:

(1) Discerning between fixed cash payments and profit sharing (our proposed solution can offer fixed cash flows and profit sharing together)
(2) Creating a margin account
(3) Focus on long-term profitability to avoid speculation and creative accounting practices

[1] Many of the Islamic finance sources distinguish between riba (interest) and usury. Here both are used interchangeably.

(4) No implicit or explicit compounding; defaults are compensated by giving higher partnership ratio to investors
(5) Backward-looking compensation mechanism
(6) Providing separate solutions for short-term financial distress due to liquidity shortage as well as for long-term insolvency due to inefficiency.

Partnership (*Musharaka*) is known as a fundamental idea of ethical finance. This mode of finance gives flexibility to financial structure; a company fully funded through equity is free from bankruptcy. Nonetheless, partnership is not suitable in every situation. While cash flows are uncertain in partnership, providers and/or users of funds might prefer relatively certain and predictable cash flows. Fixed income securities promise stable cash flows; however, they raise the possibility of default, which impose additional expenses to businesses. When a firm approaches bankruptcy, cost of funds skyrocketed and access to new sources of funds gets cumbersome. As a result lenders acquire ultimate power to dictate their own terms and conditions. This is the root of usury.

Inflexibility of maturities is another undesirable issue of equity financing as they are generally perpetual. Providers and users of funds might prefer other maturities. Market participants might be attracted towards debt markets if they prefer shorter term involvements. FPPI, by definition, has limited maturity.

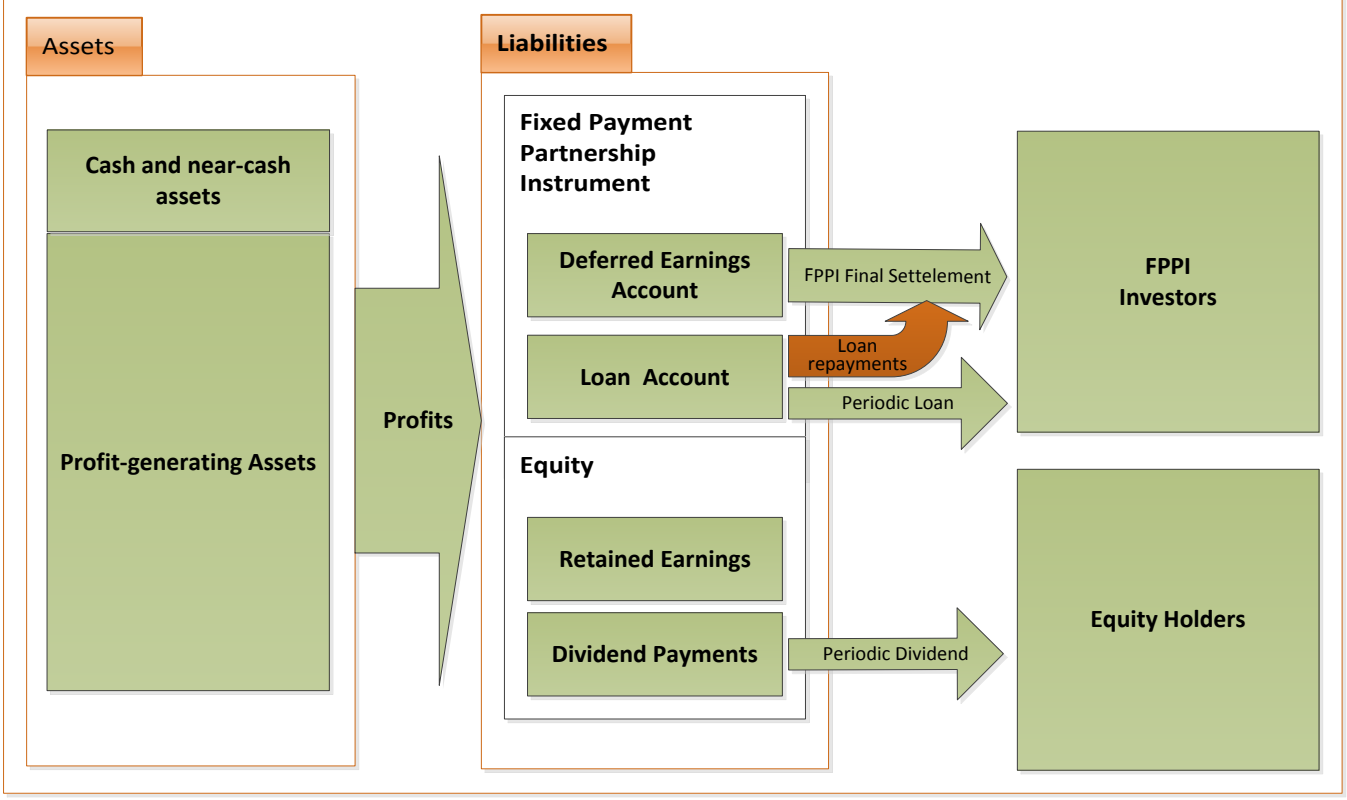
FPPI makes a breakthrough in the theory of Islamic/ethical finance: distinction between wealth distribution and cash payments. So proceeds of an investment can be assigned based on a partnership contract and still a stable cash flow mechanism can be developed. This hybrid instrument combines partnership with a series of reverse *Qard al hassan* loan contracts. Investors invest in the enterprise through a partnership contract. The profits of this venture is calculated annually and accumulated in an account, dubbed as "*FPPI deferred earnings account*" (DEA). For the cash flow needs of the investors certain amounts of cash are periodically distributed to the investors. These *Qard al hassan* loans are accumulated as the investor's liability in a "*loan*

*account*." At the maturity, returns to investment are calculated and investors settle their *Qard al hassan* before receiving the final payment.

To insure financial viability and equitable distribution three more initiatives are devised: (1) Top-up of the DEA, (2) adjustment of partnership ratio, and (3) retaking of voting right.

Figure 1 illustrates FPPI cash flows.

**Figure 1 – FPPI Cash Flow Chart**




### The mechanism

Fixed Payment Partnership Instrument (FPPI) is a substitute for corporate bonds and comprises of two parallel Sharia-compliant products: *musharaka* and a number of reverse *qard al hassans*. The first wing of this instrument is a partnership contract:

investors invest in the enterprise through FPPI for a limited time.[2] Each year, net income of the enterprise will be divided on pro rata basis between shareholders — via either "dividend payments" or "retained earnings" — and FPPI investors — accumulated in an account but not distributed. "FPPI deferred earnings account" (DEA) resembles "retained earnings account" however with limited timeframe. Thus no profit is paid until the end of the contract. At the maturity, the balance of DEA measures the profit or loss of the whole venture. After deduction of costs and other liabilities, net profit will be distributed between the two parties: the investors and the enterprise receive their shares based on a predetermined partnership (*Musharaka*) arrangement. A suggested partnership ratio could be 80% for the enterprise and 20% for the investors, which seems a fair since the enterprise would undertake measures to reduce liquidity risk in favor of the investor (discussed below).

The second wing of FPPI is a series of *qard al hassan* loan contracts. The enterprise promises[3] to provide a predetermined constant amount of cash periodically (semi-annually or annually). These are liabilities of the investors, which would be accumulated in a "*loan account*" without compounding. At the expiration of FPPI, the balance of the "*loan account*" will be deducted from the net profit share of the investors and the remainder will be paid.

To oblige the enterprise to fulfill its commitment of timely payments of periodic loans, enterprise should maintain certain level of cash or near-cash securities. For instance, a 10% minimum *cash to asset* ratio would be stipulated in the FPPI covenant. Moreover three following initiatives should be implemented:

1. <u>Top-up of the "FPPI deferred earnings account":</u> the enterprise is committed to contribute to the joint venture with the investor by all means including financial resources. As a result the enterprise (a) deposits an initial margin equivalent to two *qard al hassan* loan payments to the DEA at the outset of the

[2] Throughout of this document we refer to two counterparts of the contract as *investor* and *enterprise*
[3] Not a firm legal obligation as explained later

contract (b) at each financial year, if any loss occurs and if due to the loss the balance of DEA falls bellow 80% of the balance of the "*loan account*" (maintenance margin), a margin call takes place and the enterprise would top up the balance to equivalent amount of 100% of the "*loan account*." These transfers are deducted, first, from retained earnings account and then from shareholder's equity and is considered as the contribution of the enterprise in the venture. This top-up mechanism plays a buffer zone against future losses and will be viewed as the contribution of the enterprise into the venture. In return, the enterprise will receive higher share from the profit, say 80%. In case of inability of enterprise to top up the DEA, investors regain proportional voting right and early settlement will be called.

The top-up mechanism of the DEA restructures the right hand side of the balance sheet. In case of a loss, first DEA will bear that, then shareholders' retained earnings and finally the equity account. The concept of "margin account" is well-known in the world of finance; however, for the first time, it is used in a Shariah compliant product.

2. Adjustment of partnership ratio in case of default: in an event of default of a periodic payment, the prearranged participation shares of enterprise will be adjusted in favor of investor. For example, consider an 80% -20% partnership ratio. In case of a default, the enterprise's share will be reduced by 10% to 70% - 30%. This mechanism provides flexibility in cash outflow and mitigates bankruptcy risks related to short-term liquidity shortages. In this situation enterprise takes a break in loan payments and in return compromises on the future profitability.

   This innovative idea comes from Islamic finance. Holy Quran asserts giving respite to borrowers in difficulties [2:280]. Here default of one or several payments are legally allowed but financially discouraged. In case of an emergency, default might occur; however, it is compensated by higher partnership ratios of the future profits for FPPI investors. This method had its

edge when compared with a late payment penalty with compounding interest rate, which is common in conventional banking.

3. Retaking of Voting right: in case of long term profitability problem, higher partnership ratio might fail to remove the investor's concern. In such circumstances, investors receive higher shares in expected losses! Voting right is our response to this situation. From legal point of view, FPPI investors are owners of the enterprise; however, they would not intervene as long as the financial status of the company is satisfactory. A default will trigger a major shift: the FPPI investors retake their proportional voting rights. In an event of default, enough authority is given to the FPPI investors to contribute into the management of the enterprise through the voting right.

## 2. SOCIAL AND ECONOMIC ADVANTAGES

Our main motive for designing FPPI is to provide an advanced financial product which benefits the society. A couple of FPPI's social advantages are as follows:

- *Fewer cases of insolvency*: compared with conventional bonds, FPPI is much less likely to go to insolvency. In a competitive market FPPI makes smaller periodic payments. In a dire liquidity crisis still FPPI acquires respite by offering higher partnership ratio and returning voting right to the investors. Consequently, it virtually removes the causes for declaring bankruptcy.

- *Immune from speculative attacks*: In contemporary capital markets, common equity — the today's version of Islamic *Musharaka* — is the most trivial method of raising funds. Theoretically a company is not obliged to distribute dividend if faces financial hardship (cash flow flexibility). Notwithstanding any stoppage or even reduction in paying dividend would send a negative signal to the market. Therefore management might sacrifice long-term investment opportunities if these projects require large financial resources through which exacerbate short-term profitability: *a case of moral hazard*.

Recently new financial products are introduced to address short-termism. For instance in 2015 Toyota issued a hybrid equity product with five year lock-in period —model AA stock. The lock-in period discourages hedge funds and other short term investors to participate.

FPPI, by accumulating profits, addresses the shortcomings of equity. Therefore management targets the maturity of the contract as deadline and is immune from market reactions to the short-term cash flow fluctuations.

- *Reduction of the possibility of creative accounting*: one of the causes of Global Financial Crisis was the myopic mindset of financial managers and their tendency for short-term profit, which aggravates the global issue of creative accounting. Short-termism opens the door for window dressing of financial statements. Accumulation of profits for a long term reduces desirability and feasibility of window dressing.

- *Lower periodic payments*: although the periodic payments of FPPI resemble bonds' coupon payments, the payments of FPPI would be lower than conventional bonds. The reason is that FPPI investors receive part of the profit of their venture at the end of the contract. Therefore, FPPI benefits from higher levels of demand.

## 3. SHARIA COMPLIANCE

Riba is discussed in 11 verses of the Holy Quran. These verses discuss three concepts: (1) what is Riba and what is not? (2) how should a lender treat a debtor? (3) how severe would be the punishment for whom devour Riba?

Here we briefly discuss the first two concepts and then investigate the relevance of our solution to the spirit of these verses of the holy Quran.

*(1) <u>What is Riba and what is not?</u>*

Three versus of the Quran provides indications for the true meaning of Riba:

- *ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper*. [2:280]

  This verse states "doubled and multiplied." In other words, riba is a mechanism of wealth transfer that grows in multiples. Although this broad definition is subject to many interpretations, compound interest rate is definitely included.
- *That they took usury, though they were forbidden; and that they devoured men's substance wrongfully…* [4:161]

  Here the holy Quran indicates that in riba substance (wealth) of men (mankind) is devoured wrongly. Two elements can be recognized: first, wealth of people are taken over; second, this process is unjust (wrong). Again compound interest rate exemplifies this verse.
- *That which ye lay out for increase through the property of (other) people, will have no increase with Allah…*[30:39]

  This verse again emphasizes on growth of wealth through appropriation of the properties of other people. All the three definitive verses indicate that the lender enjoys some types of enforcing power.
- *That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury*. [2:275]

  Here the Script clearly distinguishes between riba and trade. The verse responds to the claim of usurers that trades are similar to riba and asserts that trade is Halal but riba is not. One possible characteristic for trade is a win-win game; however, riba is a one-way road that the usurer exploits assets of the debtor.

(2) How a lender should treat a debtor?

*If the debtor is in a difficulty, grant him time till it is easy for him to repay*. [2:280]

In this verse, believers are commanded to grant time to a debtor in difficulty. How could those who really are in difficulty be distinguished from pretenders?

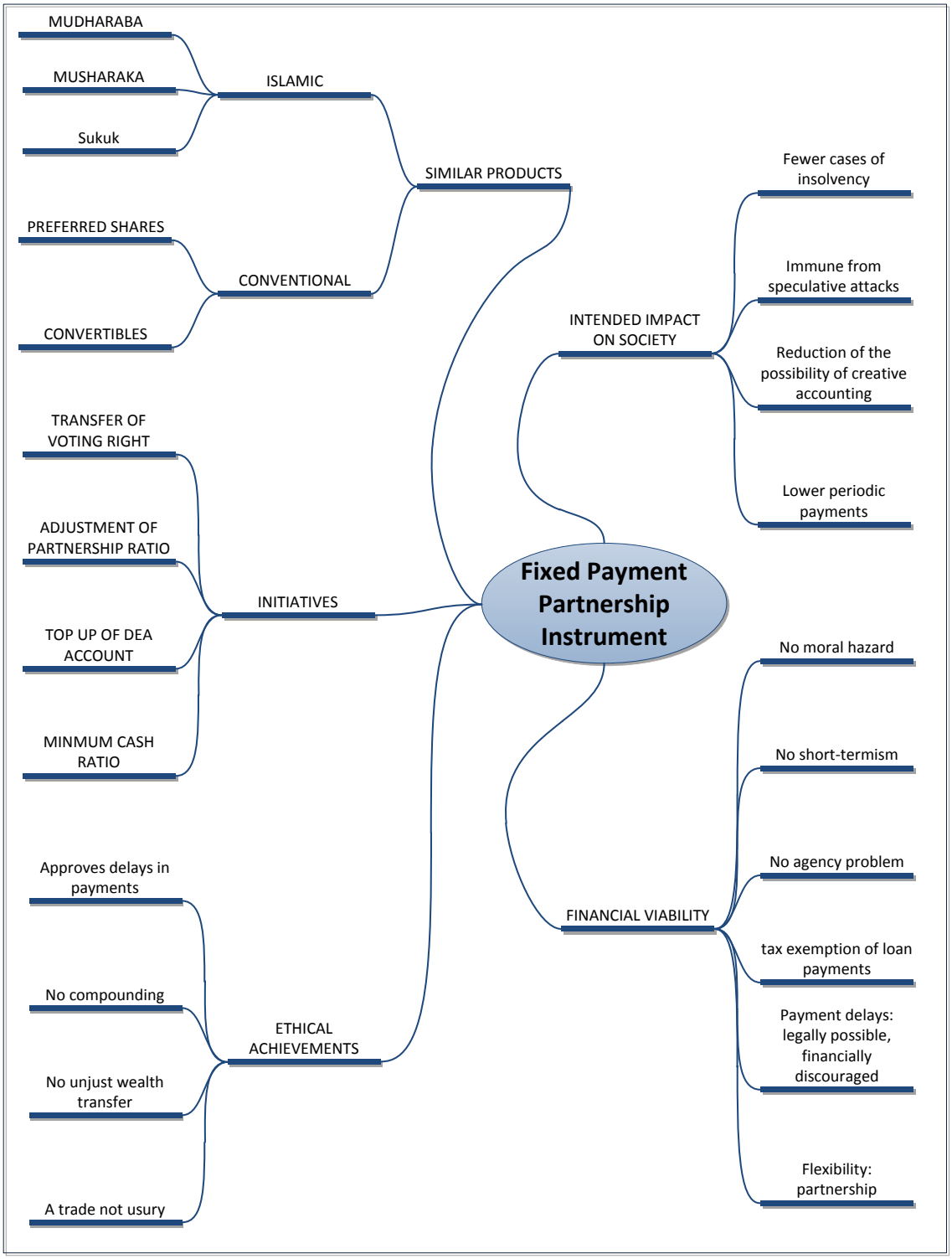
FPPI addresses all the above-mentioned points:

- There is no compounding in FPPI. All the profits and losses are calculated based on a partnership arrangement.
- There is no possibility of unjust transfer of wealth from borrower to lender. In the worst case scenario, the FPPI investor can receive 100% of the benefits of the venture and the rest of the business remains safe.
- FPPI is a trade not usury. It is a win-win contract between the investor and the enterprise. If the venture is booming both sides gain and if it is busting both sides lose. There is no mechanism to transfer wealth from borrower to lender in unfavorable economic conditions similar to compounding.
- FPPI approves delays in payment in case of difficulties; however, if the business turns out to be profitable again, higher share is dedicated to the lender.

A majority of the existing Islamic products rooted in conventional banking ideas, which are trimmed to be Sharia compliant. Most of contemporary Islamic products are the reversed engineered versions of their conventional counterparts. In contrast, here we endeavored to provide a solution to the current unresolved issues in the world of finance, meanwhile to adhere to the principles of Sharia jurisprudence. This solution agrees with both letters of the law and spirit of the law of Islamic finance. Nevertheless, no product is a panacea for all the situations and is fully complied with the variety of interpretations of Islamic schools of thought. FPPI is not an exception; however, it is a step forward towards recognition of Islamic products in the entire financial world.

Furthermore, the main argument in favor of conventional banking is the “time value of money.” Lender sacrifices cash flow now, thus should be compensated for the delay in returning the fund. This reasoning is void in FPPI. The investor sacrifices a lump sum at the beginning of the contract; the enterprise sacrifices a series of cash flows as *Qard al Hassan* over the tenor of the contract. Both parties are equality treated and no justification for riba.

**Figure 2 – Concept of FPPI**




## 4. FINANCIAL VIABILITY

Recent surveys on the prevalence of different types of Islamic contracts indicate that

*Murabaha* and *Ijara* (leasing) are the most widely used forms of contracts. On the other hand, PLS contracts such as *Musharaka* and *Mudaraba* are underutilized. Financial viability might explain these stark differences. *Murabaha* and *Ijara* is a reversed engineered version of its counterparts. No conventional product is closer to *Musharaka* and *Mudaraba* than equity participation, which is not the main focus of the banks. Here we concentrate on *Musharaka* as the most well-known Islamic product among scholars and introduced new features to make it financially viable. In this regard, a *minimum cash ratio* is stipulated as a clause in the FPPI covenant in order to enhance the liquidity status of the enterprise and mitigate the possibility of cash shortage.

Also, the regular payments to the investor as reverse *qard al hassan* would soothe their thirst for predictable cash flows. One positive point of FPPI is that because the investors are given the opportunity to receive their share from the profit at the end of contract, their expected cash payout ratio will be lower relative to the equivalent products in the conventional bond markets. Lower periodic cash payout ratio results in lower liquidity stress for the enterprise.

FPPI is a bundle of different creative ideas, of which compensating defaults with higher share in profit is quite original. Adjustment of partnership ratio can eradicate the need for compound interest rates from the markets. The primary rule of financial viability calls for discouraging of defaults; otherwise, moral hazard comes into effect and defaults rise steeply. The chief response of conventional banks to default is applying compound interest rates. Based on compound interest rate convention, indebtedness increases exponentially. Any default should be addressed immediately otherwise it becomes unmanageable. It is evident that compound interest rate is an overreaction to the issue of default.

Our response is fair and ethically acceptable: default is legally permitted but financially discouraged. The maximum possible penalty for severe financial distress with several defaults is taking over the entire (100%) accumulated profit (DEA), while

compounding is an unlimited punishment.

FPPI distributes profits at the maturity. This long-term strategy discourages short-term manipulation of financial statements by the management (window dressing). Consequently, the financial reports are more reliable. Also the long-term vision of FPPI encourages the management to take on long term profitable projects. This removes moral hazard and enhances profitability in the long run.

Furthermore, FPPI reduce the serious "agency problem." Corporations often partially distribute dividends and keep the remainder as "retained earnings." This accumulated profit remains in hand of the management forever. In contrast, DEA has a maturity, when all the deferred earnings should be distributed based on the partnership ratio.

Another advantage of FPPI is that the fixed payments are tax-exempt, because the periodic payments are loan and not dividends.

## 5. COMPARABLE PRODUCTS

First, let's explore the existing conventional responses to the problem of compound interest obligations. Two groups of solutions are used in practice: **(1) hybrid instruments**, namely "convertible bonds" and "preferred shares;" **(2) protection under bankruptcy laws**.

**(1) Hybrid instruments:** these instruments are designed to offer the advantages of both debts and equities.

*Convertible bonds/ notes/ debentures* are bonds with an option or a warrant to be converted into some certain amounts of shares after some periods. These instruments are invented to entice investors into an enterprise with weaker credit standing but higher potential for growth. Convertibility is a valuable feature; as a result their coupon rates are lower than equivalent non-convertible bonds. An

advantage to the bondholders is that these are considered as debt instruments and the coupon payments are tax exempted.

Two flip sides are known for convertibility: (1) value to equity holders dilutes upon conversion, (2) bondholders are rewarded with equities in the future and equities are forward looking financial instruments. Convertibility is a feature that transfers wealth from equity-holders to bondholders and might be unjust to equity holders. To fix this problem we need to reward the investors over the same periods of investment, not beyond that. Suppose that a high-tech company is funded by 50% equity and 50% five-year convertible bonds. In the first five years of the business, the company has monopoly and market power. Consequently the company generates extra amounts of profit. Over the first five years only shareholders benefit from the market conditions. At the end of this period, suppose competitors would enter the market and monopoly profits vanish and the share price tanks. Now even if bondholders use their convertibility option, they further dilute shareholders' equity and do gain next to nothing. The solution is that bondholders somehow benefit from the vintage years of the windfall earning not the upcoming years. The opposite is true as well. If bondholders invest for a limited time and shareholders give unlimited commitments and the business needs warm-up time, it is unjust that bond-holders gain wealth through conversion at the expense of long-term investors, who are equity holders.

Compared with convertible bonds, FPPI investors receive reasonable cash flows over the term of the contract but will be benefited a partnership bonus for the years of participation not for the future profitability through conversion to equity. Another advantage of FPPI is that the partnership share of profits will be cumulative and will be distributed at the end of the contract and therefore it is relatively immune from short-term speculative strikes. On the other hand, in a competitive market profit partnership reduces the need for periodic payments and very similar to convertibility the size of periodic loans reduces.

*Preferred shares / stocks* are shares with limited voting right however with a promised (preferred) dividend rate. A variety of preferred stocks are invented. Preferred stocks could be issued for limited time or could be perpetual; their dividend payments could be cumulative or non-cumulative; and they could be participating or not. The concept of preferred is closer to the concept of ethical banking in that the dividend/profit/interest of these instruments are not compounded. This is a plausible feature to the users of funds but might be detrimental to the investors, because the company might delay the payments with impunity. Inspired from Islamic finance, FPPI provides a fair solution to this issue: although the user of funds can legally delay a payment, any delay triggers changes to the term of the partnership to the benefit of the FPPI investors. This solution gives the enterprise legal freedom to delay a payment in case of short-term liquidity crisis; however, the investor receives compensation through higher participation share in the future profit, not compounding interest payments or fines.

**(2) Protection under bankruptcy laws:** in economies where debt financing is extensive, the issue of usury is addressed by legal protection for the borrowers against lenders' abusive measures under the court of law. In practice, this legal mechanism has been successful in some cases. The main problem is that this solution is time-consuming and late. Enterprises would seek the protection from the court of law only in case of severe financial distress. Borrowers and lenders can make a prearranged deal for chaotic times and this is exactly what FPPI does.

Two causes are observed for insolvency: (1) short-term liquidity problems and (2) long-term profitability issues. Nowadays most of the bankruptcies are due to liquidity crises, which could be avoided, if businesses get access to a mechanism to exchange their long-term brighter profitability prospect with their current short-term cash flow issues.

FPPI provides enough flexibility to avoid declaring bankruptcy by skipping some payments in exchange for higher participating share from the future profits. This flexibility of FPPI protects enterprises against insolvencies due to cash shortages and would be beneficial to both enterprises and investors.

Other similar products to FPPI are Sukuk which are the equivalent to conventional bonds. Surprisingly bonds and Sukuk have more in common than one might think. In November 2007, Sheikh Muhammad Taqi Usmani, president of AAOIF, severely criticized the existing Sukuk structures available in the market. He pinpoints three elements that should distinguish Islamic products from the conventional bonds:

- Islamic products must provide genuine ownership in the assets of enterprises.
- Any payment to the holders of Sukuk should reflect the real profit from the assets of enterprise.
- At the end of the contract market value, not the face value, of the assets should be returned to the investors.

We found Sheikh Usmani's criticism valid in the sense that majority of Sukuk in the market mimic closely their conventional products, as he puts "Islamic banks were not established so that they could offer the same products, and engage in the same operations, as conventional banks in the prevalent interest-based banking system."

In the design of FPPI, we made efforts to resolve the above concerns. FPPI gives legal ownership to the investor. For instance, the FPPI investor will hold the power of assigning board members if the financial status of the enterprise is unsatisfactory. At the end of the contract the true profit/loss will be calculated and upon that the final settlement is effected. Therefore this product is not capital protected; however, the accumulation of capital and other initiatives reduce the possibility of losses.

As a conclusion, FPPI does not guarantee the principal or profitability of the venture; however, it mitigates dramatically the liquidity risk over the tenure of the contract.

## 6. Concluding remarks

Riba is discussed in 11 verses of the Holy Quran. These verses discuss three concepts: (1) what is Riba and what is not? (2) how should a lender treat a debtor? (3) how severe would be the punishment for whom devour Riba?

FPPI addresses all the above-mentioned points:

- There is no compounding in FPPI. All the profits and losses are calculated based on a partnership arrangement.
- There is no possibility of unjust transfer of wealth from borrower to lender. In worst case scenario, the FPPI investor can receive 100% of the benefits of the venture and the rest of the business remains safe.
- FPPI is based on trade not usury. It is a win-win contract between investors and enterprise. If the venture booms both sides will gain and if it busts both sides will lose. There is no mechanism to excessively transfer wealth from borrower to lender in unfavorable economic conditions as exists in compounding interest mechanism.
- FPPI approves delays in payment in case of difficulties; however, if the business turns out to be profitable again, higher shares are dedicated to the lender.

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## **APPENDIX** Verses of Holy Quran related to Riba

الَّذِينَ يَأْكُلُونَ الرِّبَا لَا يَقُومُونَ إِلَّا كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسِّ ذَٰلِكَ بِأَنَّهُمْ قَالُوا إِنَّمَا الْبَيْعُ مِثْلُ الرِّبَا وَأَحَلَّ اللَّـهُ الْبَيْعَ وَحَرَّمَ الرِّبَا فَمَن جَاءَهُ مَوْعِظَةٌ مِّن رَّبِّهِ فَانتَهَىٰ فَلَهُ مَا سَلَفَ وَأَمْرُهُ إِلَى اللَّـهِ وَمَنْ عَادَ فَأُولَـٰئِكَ أَصْحَابُ النَّارِ هُمْ فِيهَا خَالِدُونَ ﴿٢٧٥﴾

**[2:275] Yusuf Ali**

Those who devour usury will not stand except as stand one whom the Evil one by his touch hath driven to madness. That is because they say: "Trade is like usury," but Allah hath permitted trade and forbidden usury. Those who after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah (to judge); but those who repeat (The offence) are companions of the Fire: They will abide therein (for ever).

وَإِن كَانَ ذُو عُسْرَةٍ فَنَظِرَةٌ إِلَىٰ مَيْسَرَةٍ وَأَن تَصَدَّقُوا خَيْرٌ لَّكُمْ إِن كُنتُمْ تَعْلَمُونَ

**[2:280] Yusuf Ali**

If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if ye remit it by way of charity, that is best for you if ye only knew.

يَا أَيُّهَا الَّذِينَ آمَنُوا لَا تَأْكُلُوا الرِّبَا أَضْعَافًا مُّضَاعَفَةً وَاتَّقُوا اللَّـهَ لَعَلَّكُمْ تُفْلِحُونَ

**[3:130] Yusuf Ali**

O ye who believe! Devour not usury, doubled and multiplied; but fear Allah; that ye may (really) prosper.

وَأَخْذِهِمُ الرِّبَا وَقَدْ نُهُوا عَنْهُ وَأَكْلِهِمْ أَمْوَالَ النَّاسِ بِالْبَاطِلِ وَأَعْتَدْنَا لِلْكَافِرِينَ مِنْهُمْ عَذَابًا أَلِيمًا

**[4:161] Yusuf Ali**

That they took usury, though they were forbidden; and that they devoured men's substance wrongfully;- we have prepared for those among them who reject faith a grievous punishment.

وَمَا آتَيْتُم مِّن رِّبًا لِّيَرْبُوَ فِي أَمْوَالِ النَّاسِ فَلَا يَرْبُو عِندَ اللَّـهِ وَمَا آتَيْتُم مِّن زَكَاةٍ تُرِيدُونَ وَجْهَ اللَّـهِ فَأُولَـٰئِكَ هُمُ الْمُضْعِفُونَ

**[30:39] Yusuf Ali**

That which ye lay out for increase through the property of (other) people, will have no increase with Allah: but that which ye lay out for charity, seeking the Countenance of Allah, (will increase): it is these who will get a recompense multiplied.

**NOTE:** You may attach additional documents / details that may facilitate better understanding of the product / solution / initiative. However, there is no guarantee that the executive committee will read them and therefore, your product / solution / initiative must stand on the merits / contents of this application.