

# Availing Shariah Compliant Debt by Businesses

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It is commonly known that interest bearing debt is not permissible under Shariah principles. This leads to a situation of Shariah compliant organizations having to pay high rates of tax because of the absence of financial leverage in their capital structure. Moreover, having to rely only on their own resources at all times, such businesses often fail to snap up lucrative opportunities for profit and growth due to inability to raise short term funds.

Is there any way for a company to remain Shariah compliant in spite of raising debt?

Equity-linked debt or debentures (ELD) could be an option. For such an instrument to be acceptable under Shariah however, all equity holders will need to subscribe to the debt in a fixed ratio of ELD: Equity. Hence it could be a feasible option only if it is properly pre-planned and implemented from the inception stage itself; otherwise it will be difficult to maintain uniformity of the ratio across all shareholders. It would also require specific Articles to be included in the Articles of Association, to enable simultaneous subscription to and subsequent transfers of proportional units of equity and debt (in the form of debentures of long maturities). Another issue would be handling of roll-over of debt on maturity of the debt.

The main benefit of such an instrument would be an effective lowering of the tax liability of the company. The return earned on the debentures would be pre-tax in the hands of the debenture holders (who would also be shareholders). The advantage would be an effective transfer of taxation liability on invested funds from the company to the shareholders. As the tax rate for individual shareholders is likely to be less than that of the company, the net effect can only be beneficial for the investors. Secondly, in effect transferring the tax liability to individual shareholders/debenture holders yields an additional opportunity for managing the demands of the taxman.

A distinct advantage of ELDs is that there is no prescribed ceiling for the ratio of debt to equity in such cases as all the lenders are shareholders. Another attractive aspect is that any return paid on the ELDs ultimately only benefits the owners of the company. Hence, by varying the rate of return, the tax can in fact be even further reduced. Even if the return on the ELDs leads to a loss on the books of the company, from a Shariah perspective there is no problem.

The main problem with ELDs is that they represent a rigid structuring. The company (and the shareholders) are locked into a capital structure which cannot be varied over fairly long periods. While raising additional capital may be feasible, downsizing

is difficult, as it would imply buying back a proportional part of the equity along with the reduced debt.

Perhaps an easier and more flexible option could be a profit-sharing debenture. It needs to be stressed that technically, interest is not integral to debt. Debt in fact goes hand in hand with commercial transactions. Many business transactions inevitably imply a period of indebtedness for one party or the other. Interest most often comes in when there is an issue of funding. However this only reveals that interest is merely a mechanism for providing an advantage to the person who holds capital. It is not legally a necessary part of a transaction involving debt.

The return to the person holding the capital can as well be structured in accordance with a formula linked to the expected profit of the transaction/business. Actually the essential feature of debt is that, by contract, the principal amount of the debt has to be repaid irrespective of the outcome of the transaction/business. This means that the return on debt need not be fixed, and it also need not be decided in advance but can be determined post a certain specified event or period and in accordance with pre-agreed parameters. Thus the return on debt can be variable. However, a creditor cannot be made liable to write off a part of the principal of his debt. These two aspects of debt are not merely etymological deductions; they enter into the legal definition of debt.

Hence there is no problem with paying a variable (but non-negative) return on debt. The problem from a Shariah perspective lies in debt not being liable for losses. A partial solution to this issue could be to allow, in the event of a loss, a carryover of the (loss) results on the debentures in the P&L (only for the purpose of calculating return on the debenture), to a specified maximum number of later periods. The carryover feature would allow the losses to be carried over in the P&L up to the end of the specified tenure and/or up to a specified maximum number of years thereafter, if necessary (to allow carryover of losses for a specified minimum number of years before write-off). Eventually (if the losses persist till the end of the specified period), proportional write-off of the debt to the extent of the loss in the P&L would be necessary to ensure Shariah compliance. Perhaps an example could clarify:

Assume a company raises debt by public issue (or more likely, private placement) by means of debentures with following features:

- a. Tenure of minimum 7 or 9 years.
- b. Tenure could be extended by another 1 to 2 years.
- c. Minimum carryover period before write-off of proportional part of Debt will be additional 2 years, but not before end of primary tenure.

(Hence, in case losses appear in the 6th or 7th years and thereafter they remain uncompensated, the tenure can be extended by another 1 or 2 years respectively).

d. Return on debentures calculated according to a specific profit-sharing formula such as

$$k \times \text{PBT} / (\text{Equity} + \text{Debt}), \text{ where } k \text{ is a factor which is less than } 1$$

(by adjusting the value of  $k$  - fixed at inception itself - Debt can be given

a return, as desired, equal to or less or more than the expected pre- or post-tax

return to Equity; however Debt will not be entitled to a share in appreciation of

capital values; at the same time, depreciation will be charged on the basis of

useful life of assets concept)

e. If there is accumulated loss in P&L, Debt will be proportionately written-off according to the formula

$$\text{Debt} * (\text{Accumulated Loss}) / (\text{Equity} + \text{Debt})$$

Except for feature e. above, which runs counter to the legal definition of debt, the debenture would be a workable solution. As far as e. is concerned, it could be replaced by a mutual understanding or other informal arrangement.

Sometimes the question is raised whether Shariah allows a certain tolerance limit within which a business organization can borrow. It should be clearly understood that such tolerance limits are allowed by Shariah scholars as a concession for debt in the capital structure of investee companies only in the specific case of investment by lay investors in equity shares listed on the stock market in geographies where non-interest based investment options are not yet sufficiently developed. Any debt allowed in own operations of companies which are to be certified as Shariah compliant per se has to be either on the basis of zero coupon (and with no implicit benefits or privileges), or specifically structured (as in the two cases discussed above), to comply with Shariah stipulations. There is no question of a blanket allowance of conventional interest-bearing debt to any extent.

An exception that can be visualized to the above rule is if the Shariah compliant company takes over or takes a stake in another existing company which already has interest-bearing debt on its books. In such an event the existing debt could be tolerated for a limited period subject to a definite restructuring program which would ensure phased liquidation of the interest-bearing debt by the end of the restructuring phase or earlier.