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THE GLOBAL UNIVERSITY OF ISLAMIC FINANCE

Session 5: Capital Markets & Alternative Business Models for Financial Institutions

"Catalysts for Economic Development and Sustainability"

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Current structure of corporate finance

tradeoff between debt & equity

Capital structure of firms in conventional includes only debt and equity each with its own well known advantages and disadvantages. Firms have to undertake a balancing act of getting the trade-off right.

Debt / Equity tradeoff

If issue debt

- Increase leverage, BEP
- Increase volatility of returns
- Potential for risk shifting or asset substitution

If issue new equity

- Less risky than debt but dilution of ownership / earns.
- Potentially adverse signasl to the market

Greater Flexibility in the capital structure with risk sharing: Mudharabah/Musharakah

Risk Sharing Finance relative to debt

- With risk-sharing instruments, returns based on profits/losses.
- No fixed claim on the company's cash flow. No increase in the firm's break-even point.
- Nor will there be an increase in the firm's financial leverage. (no increase in risk!)
- With returns tied to company earnings, risk sharing financing can act as an in-built stabilizer.

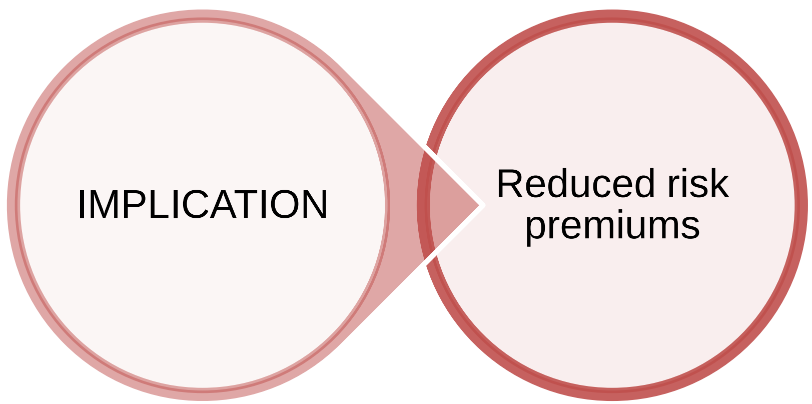
Risk Sharing Finance relative to equity

- If new shares are issued, these would rank hand-in-hand with existing shares, thereby diluting ownership of all assets of the firm.
- With musharakah/mudhrabah sukuk issuance, however, there is a major if subtle difference. Sukuk holders have a right of claim on only the profits generated by the new asset(s).
- No ownership dilution since the sukuks are specific to the new project being financed.

What's the alternative to reliance on debt and a solution to the ever-present SME finance constraint?

Risk sharing finance

- Risk sharing instruments like Mudarabah/ Musyarakah sukuk may be the answer to these twin problems;
- *Sukuk* is a hybrid instrument that has the features of both debt and equity without the disadvantages of both, allowing flexibility in firms' capital structure;
- With risk sharing finance, the SME gets the benefit of equity issuance without the dilution and relaxation of finance constraint without the burden of debt;
- Yet, like equity issuance, there is reduced cash flow volatility while financial flexibility is intact.



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