

PROFIT AND LOSS SHARING (PLS) IN NON INTEREST FINANCE: A VIABLE ALTERNATIVE TO INTEREST-BASED LENDING

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Abstract

This paper explores the concept of Profit and Loss Sharing (PLS) in non interest finance as an alternative to conventional interest-based lending. Rooted in Islamic law (Shariah), PLS aims to promote equitable wealth distribution and ethical financial practices. By examining theoretical foundations, empirical studies, and methodological frameworks, this paper evaluates the viability of PLS mechanisms primarily mudarabah and musharakah as sustainable and socially responsible financial instruments. The study concludes that while PLS holds substantial promise, however practical implementation challenges must be addressed for broader adoption in modern financial systems.

Keywords: Islamic finance, PLS, Interest based lending.

Introduction

The conventional banking system heavily relies on interest (riba) as a central mechanism for credit and investment. However, Islamic finance, guided by Shariah principles, prohibits riba and instead promotes risk-sharing and ethical investment practices. One of the most prominent models in Islamic finance is Profit and Loss Sharing (PLS), which fosters partnership, equity, and transparency between financiers and entrepreneurs. PLS structures are often proposed as a morally and economically viable alternative to interest-based financing. This paper investigates whether PLS can provide a practical substitute in a modern financial context by analysing both theoretical underpinnings and real-world applications. According to Udovitch (1970), "the Islamic PLS modes of financing (Mudarabah & Musharakah) were able to mobilize the entire reservoir of monetary resources of the medieval Islamic world for financing agriculture, crafts, manufacturing and long distance trade. They were used not only by Muslims but also by Jews and Christians." Abdulrahman et al. (2014) strongly contend and support the improved application of PLS in Islamic Banks. They maintain that the theoretical literature on Islamic banking strongly supports the notion of adopting the PLS contracts and believe that it would increase the value of Islamic banks and make them resilient to crisis.

Background

The traditional banks in the world started banking business a few hundred years ago. They were taking deposits from the people in the savings and current accounts and were giving loan to people for interest (riba). Riba (interest) is prohibited in Islam. So, Islamic financial system cannot operate based on riba (Rahman, 2007). As those traditional banks were operating based on interest, Muslim scholars in the world were thinking for a long time how to develop a banking system which will be operated based on shariah (Islamic law) principles and will not take any interest on loan given to people. They were thinking to operate Islamic banking based on profit-loss sharing mechanism which is approved by shariah. In 1973, extensive collective efforts were taken by Muslim scholars who are knowledgeable in Islamic fiqh (law), economy and banking system, to establish Islamic banking system which will meet the need of Muslims who do not want to take or give loan for interest (Nasir, M. et al, 2008).

The idea of Islamic banks with profit-loss sharing (PLS) as its main instrument initially started only from the stage of thought and discussion in the early 1900s. This coincided with the decreasing dominance of the Islamic Kingdom along with the increasingly massive expansion carried out by European countries (Alharbi, 2015). The thought that emerged in the early 1900s was a response to the massive increase in the use of conventional banks. The concept of profit loss sharing was originally often called "a wish full thinking" (Iqbal and Molyneux, 2016) and only spread in the realm of scientific discussion.

In the Islamic perspective, Profit and Loss Sharing (PLS) is a core principle in Islamic finance, replacing interest-based transactions with participatory models like *mudharabah* and *musharakah*. These models involve sharing profits and losses based on agreed-upon ratios, aligning financial activities with ethical and religious principles. The core principles of PLS are presented below as follows:

- i. **Shirkah (Partnership):** PLS is rooted in the concept of *shirkah*, where parties jointly invest in a project and share in both profits and losses based on their ownership stake.
- ii. **Mudharabah (Profit-Sharing):** A contract where one party (the financier) provides capital, and the other party (the entrepreneur) manages the business. Profits are shared according to a predetermined ratio, with losses borne by the financier.
- iii. **Musharakah (Joint Venture):** A partnership where partners invest capital and share in profits and losses based on their contribution, offering a more direct form of investment participation.

These will also show the key aspect of PLS under Islamic views in terms of

- i. **Risk Sharing:** PLS promotes risk sharing by involving all parties in both potential profits and losses, aligning incentives with sustainable development.
- ii. **Equity and Social Justice:** PLS aims to promote economic fairness by distributing wealth and fostering participation in economic activities.
- iii. **Ethical Compliance:** PLS ensures that financial transactions adhere to Islamic principles, avoiding interest (*riba*) and promoting socially responsible investing.
- iv. **Financial Intermediation:** PLS allows Islamic financial institutions to act as intermediaries, channeling funds from savers to investors while adhering to ethical guidelines.

The perspective of Islam in any aspect of life is how beneficial these Islamic banking concepts can become to individual who practice such. Some of these benefits of PLS are:

- i. **Alternative to Interest:** PLS provides an alternative to interest-based financing, complying with Islamic principles.
- ii. **Risk Management:** PLS fosters a culture of risk sharing, encouraging responsible investing.
- iii. **Social Impact:** PLS can contribute to social and economic development by promoting participation and aligning financial activities with ethical values.

In essence, PLS in Islamic finance is a powerful tool for promoting ethical and sustainable economic activities, aligning with the principles of equity, risk sharing, and social justice

Theoretical Framework

Islamic Economic Theory

Islamic economic theory is built on justice, mutual cooperation, and risk-sharing. The central premise is that money should not be used to generate profit without engaging in productive activities or bearing risk. Shariah-compliant finance thus avoids *gharar* (excessive uncertainty), *maysir* (gambling), and *riba* (interest)

Theories of Profit and Loss Sharing (PLS) in Islamic Finance: An Islamic Perspective

Profit and Loss Sharing (PLS) in Islamic finance is grounded in Islamic jurisprudence (*fiqh al-muamalat*), which provides a framework for conducting financial transactions in a just and ethical manner. Below is an explanation of the theoretical foundations of PLS from an Islamic perspective.

- i. **Foundations in Shariah (Islamic Law)**
- ii. **Prohibition of Riba (Interest):** The most fundamental principle in Islamic finance is the absolute prohibition of *riba* (usury or interest). This is clearly stated in:
 - **Qur'an 2:275:** "Allah has permitted trade and forbidden *riba*..."
 - **Qur'an 2:279:** "If you do not give up *riba*, then be warned of a war from Allah and His Messenger."

The rejection of riba creates the foundation for alternative, Shariah-compliant financial mechanisms like PLS.

iii. Theory of Risk and Profit

Al-Ghunm bi al-Ghurm (Gain with Risk): A core Islamic economic principle is that one is entitled to profit (*ghunm*) only if one bears the risk (*ghurm*). This principle justifies PLS as profits should be earned through shared risk-taking and effort. This aligns with the prophetic tradition: “Profit is a return for bearing risk.” (*Sunan al-Tirmidhi*) and also Profit without Liability which According to Islamic jurisprudence, liability for loss must accompany the entitlement to profit. This principle ensures fairness and discourages exploitation, particularly of the weaker party in a transaction.

iv. Theories of Partnership in Islamic Jurisprudence

Islamic scholars have long developed legal theories around partnership-based contracts, which form the theoretical foundation for PLS models.

a. Mudarabah (Trust-Based Profit Sharing) One party provides capital (*rabb al-mal*), and the other (*mudarib*) provides labor/management. Profit is shared according to a pre-agreed ratio. Losses are borne solely by the investor unless negligence or misconduct by the manager is proven. The rationale behind the theories are: Based on trust and mutual cooperation, Encourages entrepreneurship and capital mobilization and rooted in early Islamic practices, including those used by Prophet Muhammad (PBUH) and Khadijah.

b. Musharakah (Joint Venture or Equity Participation) all parties contribute capital and share profits and losses proportionally. Can be permanent or diminishing (as in diminishing *musharakah*). Theoretical Rationale believes in emphasis on mutual risk-taking and cooperation. Suitable for long-term investments and business partnerships.

v. Maqasid al-Shariah (Objectives of Islamic Law)

The broader **goals of Shariah** (*maqasid*) also underpin the PLS theory, particularly:

- a) **Justice ('adl):** Fair distribution of wealth and prevention of exploitation.
- b) **Wealth Circulation (tadawul al-tharwa):** Encouraging productive investment and circulation of capital.
- c) **Risk Sharing (ta'awun):** Promoting solidarity and shared responsibility in economic life.

PLS aligns with these objectives by ensuring that profits are earned through legitimate effort and mutual risk, rather than through fixed, risk-free returns.

Economic Rationality in Islamic Thought

Islamic finance is not just a legalistic system but is also informed by an ethical and socio-economic rationale to encouragement real economy linkages as PLS ensures that financial transactions are tied to real economic activity, reducing speculative behaviour and moral responsibility in terms of financial decisions which are seen as moral choices, impacting society and subject to accountability before God.

The theory of Profit and Loss Sharing in Islam is rooted in justice, shared responsibility, and real economic value creation. It promotes a partnership-based financial system where all stakeholders share in the risks and rewards, thus aligning economic incentives with ethical imperatives.

Profit and Loss Sharing Principles

PLS contracts are based on equity participation and include two primary models:

- i. **Mudarabah:** A partnership where one party provides capital (*rabb al-mal*) and the other (*mudarib*) manages the project. Profits are shared according to a pre-agreed ratio, while losses are borne only by the investor unless negligence is proven.

- ii. **Musharakah:** A joint venture where all partners contribute capital and share profits and losses in proportion to their equity. It allows for greater participation in management and is often used for long-term investments.

Comparison to Interest-Based Lending

In contrast to fixed-interest loans, PLS ensures that returns are linked to the performance of the underlying asset or business. This alignment of interests theoretically reduces systemic risk and encourages due diligence. Interest-based lending is a financial system where loans are issued with the expectation that the borrower will repay the principal amount plus an additional amount of money, called interest. This interest serves as the lender's compensation for providing the funds and taking on the associated risk. It works when a lender (like a bank or individual) offers a loan to a borrower and the borrower agrees to repay the loan over time, typically with regular payments. These payments include both: Principal the original amount borrowed and interest a percentage of the principal charged over time. e.g If you borrow N10,000 at an interest rate of 5% annually, you might repay N10,500 after one year (if it's simple interest). It Features are common in modern banking systems. Interest rates can be fixed (same rate for the term) or variable (changes with market conditions) and personal loans, mortgages, car loans, credit cards, are used etc.

Alternatives:

In contrast, interest-free or profit-sharing models (e.g., used in Islamic finance) avoid charging interest and may instead involve:

- i. Shared risk/profit (like Mudarabah or Musharakah).
- ii. Markup-based sales (Murabaha), where a seller adds a known profit margin instead of charging interest.

Literature Review

Classical Foundations

Islamic scholars such as Ibn Taymiyyah and Al-Ghazali emphasized the prohibition of *riba* and advocated for trade and partnership-based economic models. Modern interpretations have expanded these ideas into formal financial instruments. Several studies have attempted to synthesize research on profit-loss sharing and Islamic banking using literature review methods. One of the earliest reviews was conducted by Zaher and Hassan (2001). At that time, the growth of Islamic finance was not yet substantial, so their discussion focused more on the theoretical development of profit-loss sharing and the historical evolution of Islamic finance across different sectors. Their conclusions covered theoretical aspects, particularly the impact and potential applications of Islamic economic principles. Tahir (2007) Later provided another notable review, examining Islamic banking developments in selected countries, assessing performance benchmarks, and compiling numerous titles on Islamic economics and finance. This study identified ten areas for future research, mostly emphasizing the practical and technical aspects of implementing interest-free banking within different legal frameworks worldwide. In 2015, literature studies on Islamic finance were generally divided into two main types. The first type examines the overall development of the Islamic finance industry, as discussed by Abedifar et al. (2015) and Moisseron et al. (2015). These studies explored how Muslim economists responded to major challenges of the time and how industry practitioners advanced Islamic finance. The second type focuses on the stability of the Islamic finance industry, as seen in the work of Belouafi et al. (2015). This focus became particularly relevant after the 2008 financial crisis, when researchers widely tested the stability of Islamic finance, especially profit-loss sharing, prompting the need for a comprehensive conclusion on this topic.

Empirical Evidence

Studies from countries like Malaysia, Iran, and Pakistan reveal mixed outcomes. While PLS-based institutions show resilience during financial crises, they often underperform in terms of profitability

compared to conventional banks, due to operational complexity and lack of supporting legal infrastructure.

Profit and Loss Sharing (PLS) in Islamic finance primarily through Mudarabah (trust-based investment partnerships) and Musharakah (joint ventures) offers a compelling alternative to interest-based lending. However, despite its ethical and risk-sharing foundations, there are critical gaps that hinder its viability as a mainstream alternative, especially in contexts like Nigeria.

Key Gaps of PLS

In Islamic Finance (with Nigeria Context) is mostly in terms of

i. Information Asymmetry & Moral Hazard

- **Problem:** Entrepreneurs or borrowers may underreport profits or overstate losses.
- **Impact:** This discourages financiers from engaging in true profit-sharing models, as they cannot reliably verify business outcomes.
- **Nigeria Context:** Weak financial reporting standards and limited transparency exacerbate this risk.

ii. Weak Legal & Regulatory Framework

- **Problem:** PLS contracts require strong enforcement mechanisms for disputes, profit distribution, and asset management.
- **Impact:** this has left individuals and businesses vulnerable to data breaches
- **Nigeria Context:** The Nigerian legal system lacks tailored legislation and court expertise to handle Islamic finance disputes effectively.

iii. High Monitoring & Transaction Costs

- **Problem:** PLS requires continuous monitoring and auditing of the business to ensure fair profit-sharing.
- **Impact:** Banks and financial institutions find this costly compared to fixed interest models.
- **Nigeria Context:** Limited institutional capacity to monitor SMEs and rural businesses increases overheads.

iv. Lack of Financial Literacy and Awareness

- **Problem:** Many entrepreneurs and consumers in Nigeria are unfamiliar with Islamic finance principles and structures.
- **Impact:** Mistrust and reluctance to adopt PLS-based financing solutions.

v. Liquidity and Exit Challenges

- **Problem:** In a Musharakah model, it's hard for banks to liquidate their stake or exit without affecting the business.
- **Nigeria Context:** Underdeveloped capital markets and limited secondary trading platforms for Islamic instruments make exit planning harder.

vi. Limited Institutional Appetite

- **Problem:** Islamic banks and financial institutions often favor **Murabaha (cost-plus financing)** over PLS because it mimics conventional loans but is less risky.
- **Nigerian Context:** Most Nigerian Islamic banks, such as Jaiz Bank, rely heavily on Murabaha and Ijara, not Mudarabah or Musharakah.

vii. Shariah Governance Constraints

- **Problem:** Inconsistent or unclear Shariah rulings across regions can lead to legal uncertainty.
- **Nigerian Context:** Varying interpretations among scholars and lack of a central Shariah board complicate standardization

A short table to summarize the situation of Islamic banking.

Summary Table

Gap	Description	Nigeria-Specific Issue
Information Asymmetry	Borrower may misreport	Weak accounting systems
Legal Weakness	Poor contract enforcement	Lack of Islamic finance laws
Monitoring Cost	High admin burden	Few trained professionals
Low Awareness	Misunderstanding of PLS	Low Islamic finance literacy
Exit Difficulty	Illiquid investments	No active Islamic capital market
Institutional Preference	Risk aversion	Preference for Murabaha
Shariah Disparity	Varying interpretations	No unified Shariah council

Methodology

This study uses a qualitative approach, combining doctrinal analysis of Islamic jurisprudence with a comparative institutional review. The methodology includes:

Document Analysis

Examination of primary Islamic legal sources (Qur'an, Hadith) Review of regulatory frameworks from Islamic Financial Services Board (IFSB) and AAOIFI.

Case Studies

- Malaysia:** A dual financial system where Islamic banks utilize PLS with some success, particularly in SME financing.
- Pakistan:** National-level Islamization of the banking sector reveals both regulatory challenges and cultural adaptation issues.
- Iran:** Fully Islamic banking system, offering a laboratory-like setting for analyzing PLS in practice.

Stakeholder Interviews (Hypothetical) Insights from Islamic bankers, regulators, and customers to identify perceptions and practical challenges.

Findings and Discussion

It was found that the strengths of PLS

- Promotes risk-sharing and ethical finance.
- Encourages entrepreneurship and long-term investment.
- Reduces dependency on collateral-based lending.

Challenges

- i. Information asymmetry and monitoring difficulties.
- ii. Higher transaction costs due to the need for detailed project evaluation.
- iii. Limited investor confidence and regulatory inconsistency.
- iv. Preference for fixed-return instruments (e.g., ijara, murabaha) over true PLS modes.

Practical Viability

Despite its theoretical appeal, full-scale implementation of PLS faces significant hurdles. However, hybrid models, technological advancements (e.g., block chain for transparency), and regulatory support could enhance adoption.

Policy Recommendations for Promoting PLS in Islamic Finance

i. Develop a Comprehensive Legal and Regulatory Framework

Ensure enforceability and clarity of PLS contracts (Mudarabah, Musharakah). Draft and implement Islamic finance-specific laws. Create standardized templates for PLS agreements and strengthen dispute resolution mechanisms via specialized financial courts or tribunals.

ii. Establish a Central Shariah Governance Body

Harmonize interpretations and implementation of Shariah-compliant financial principles. Create a **National Shariah Advisory Board** for Islamic finance. Mandate Shariah audits for financial institutions offering PLS.

iii. Enhance Financial Disclosure and Transparency

Reduce information asymmetry and moral hazard in PLS arrangements. Mandate regular audited financial statements for businesses receiving PLS financing and provide training for SMEs on accounting and reporting standards.

iv. Provide Risk Mitigation and Credit Guarantees

Encourage banks to adopt PLS by reducing their exposure to loss. Set up a **PLS Guarantee Fund** or **Islamic Credit Guarantee Scheme**. Develop takaful (Islamic insurance) products to cover investment risks.

v. Introduce Fiscal and Tax Incentives

Encourage adoption of PLS by financial institutions and businesses. Offer tax deductions or rebates for income generated from PLS contracts. Provide incentives for Islamic banks that allocate a higher proportion of their portfolio to PLS.

vi. Promote Awareness and Financial Literacy

Build public trust and understanding of PLS models. Launch educational campaigns through mass media, schools, and mosques. Partner with universities to introduce Islamic finance curricula.

Recommendation of Key Policy Areas

Policy Area	Recommendation
Legal & Regulatory	Create enforceable PLS laws and contract templates
Shariah Governance	Establish national advisory body
Transparency	Mandate audited reporting for SMEs
Risk Management	Offer guarantees and takaful products

Policy Area	Recommendation
Fiscal Incentives	Provide tax breaks for PLS income
Literacy	Implement public awareness campaigns
Institutional Capacity	Train bank staff on PLS monitoring
Infrastructure	Develop secondary markets and Islamic VCs
PPP	Use government funding to back PLS projects
Fintech	Leverage technology for efficient PLS

Conclusion

Profit and Loss Sharing represents a morally grounded and economically sustainable alternative to interest-based lending. While challenges remain in implementation, particularly regarding information asymmetry and regulatory frameworks, the model aligns well with principles of ethical finance and risk sharing. Further development in institutional support, financial literacy, and technological integration could make PLS more viable in the global financial system.

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