EQUITY- BASED FINANCING

✧ In this section, we discuss the two main profit-and-loss-sharing (PLS) and equity-based financing contracts. The two major PLS (equity-based) modes of financing in Islamic finance are *mudharaba* (trustee project finance) and *musharaka* (joint venture project finance).

✧ *Mudharaba* and *musharaka* as a financing instrument are the earliest to be proposed in literature on Islamic banking.

✧ *Mudharaba* and *musharaka* are the partnership (PLS) alternative for interest-bearing transactions. They are unique to Islamic finance. They, in some sense, distinguish the Islamic finance from the conventional one on the grounds of ethics and efficiency.

✧ Unfortunately, in reality, Islamic financial institutions are not engaged in *mudharaba* or *musharaka* as they should. They engage more in less risky activities.

✧ Other *Islamic instruments such as murabaha, ijarah* and *BBA* are more commonly used although they should be restricted to cases where *mudaraba* and *musharaka* are not applicable.

✧ Mudharaba and musharaka are not widely used because contemporary Islamic banking is credit-driven, focus on risk management issues revolve around mitigating credit and default risk.

✧ Products prone to market risks (such as *mudaraba, musharaka, salam* and *istikna*) are deemed not viable to the banking business.
MUDHARABA (TRUSTEE PARTNERSHIP)

The Concept of Mudharaba

- Mudharaba is a participatory mode of financing that consists of two parties (or more) who combine human and financial capital in order to set up a potentially successful investment project and share the risk of running it together with the purpose of earning halal profit.

- The two parties are:
  1. An entrepreneur who have the necessary skills, expertise, and efforts, but lacks funds is called "Mudharib" (agent or). Mudharib seeks finance for initiating and operating the business enterprise or project.
  2. Capital provider (Rabb-ul-mal), which may be an Islamic bank, a finance company, or a private investor, that provides the required financing (fund) to the mudharib (entrepreneur);

Issues relevant to Mudharaba

- Mudharaba agreement must specifies:
  1. The amount of fund to be provided; all of the capital has to be paid at the signing of the contract. It is not allowed to pay it later or on installments basis.
  2. The terms and conditions that govern the utilization of the funds; rabb-ul-mal can impose any (reasonable) instructions and conditions on the working of the agent; if they are acceptable to the latter they become part of the contract.
  3. The profit sharing ratio,

- The General fiqh opinion, Once operation starts, the financier “rabb-ul-mal” cannot participate in management of the business and has no right to intervene in the day-to-day business. However, the exception came from “Hanbali” sect, which allows the participation of rabb-ul-mal since he/she is a stakeholder in the business, and might have valuable contribution that
may enhance the investment.

- Mudharaba mode of financing achieves the interest of both parties, the provider of the funds "rabb-ul-mal" (capital owner) and the mudharib (agent or entrepreneur).
  - Rabb-ul-mal may not have the time or the experience to invest the capital and make profit.
  - Mudharib may not have the adequate capital to put. Instead, he has only his experience and efforts.
- The provider of the funds "rabb-ul-mal" can engage in mudharaba with one person or more than one person through a single transaction. This means that he offers money, for example, to two mudharibs, so that each one of them can act as mudharib and the capital of mudharaba will be utilized by all mudharibs jointly. The share of the mudharibs shall be distributed among them according to the agreed proportion. In this case, both mudharibs shall run the business as if they were partners.
- Mudharib cannot claim any periodical salary or a fee or compensation for the work done for him.
- With the approval of rabb-ul-mal, it is permissible for the mudharib to hire an assistant if cannot do the work by himself.

**Profit and Loss**

- Profit of the venture will be shared between the two parties according to a mutually agreed upon ratio.
- Profit sharing cannot be a fixed amount or a fixed percentage of capital contribution.
- Profit sharing must be a percentage of the profit. Profit can be also divided periodically in accordance with the contract.
- If there is a loss, the capital provider bears the whole financial loss, while the mudharib loses the time and efforts he spent on the project and does not get any payment for his efforts.
✧ In case of violation of any of the terms and conditions, and/or willful mismanagement, or negligence, the *mudharib* has to bear the consequences and compensate *rabb-ul-mal* for the loss.

✧ If the investment has earned a loss in some transactions but has gained a profit in others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

**Liability**

✧ *Mudharaba* also provides for **limited liability** for the financier in line with the modern equity contract. The liability of the *rabb-ul-mal* is limited to its investment in the project. This is quite rational and fair, since *rabb-ul-mal* does not participate in the managerial decision-making and cannot be held responsible for the risks created by the *mudharib*.

**Risks Associated with Mudharaba**

✧ *Mudharaba* is a high-risk mode of finance because the *rabb-ul-mal* provides capital to the *mudharib* relying completely on his integrity, ability and good management.

✧ *Mudharib* undertakes the work and management and is only a guarantor in case of negligence and trespass. *Rabb-ul-mal* is not only risking the expected return but also the capital itself.

✧ However, Islamic banks usually take the necessary precautions to decrease the risk and to guarantee a better execution for the *mudharaba* and pursue this objective with seriousness. They were able to develop a new *Shari'a* based forms of *Mudharaba* with significantly reduced degrees of risks. For example:

  ∙ *Mudharaba* is used only with public limited companies, where a reasonable degree of transparency is possible i.e. audited accounts, and quarterly reported performance.
Banks finance on mudharaba basis only those projects where success is feasible.

- It is permissible to take securities and guarantees or mortgage from the mudharib to guarantee the payment in case of negligence, mismanagement or violation of conditions, but it is impermissible to take that as a guarantee to capital or profit, because it is impermissible for the mudharib to guarantee capital nor profit.

**Types of Mudharaba**

- Mudharaba may be of two types - restricted or unrestricted.
  1. **Restricted Mudharaba** (Al-Mudharaba al-muqayyada) in which the entrepreneur’s activity is restricted in terms of type of business, method, time period or place. Restriction must not result in a constriction on the agent to attain the profit required and is not counterproductive to the purpose of the Mudharaba.
  2. **Unrestricted Mudharaba** (Al-Mudharaba al-mutlaqa) in which the entrepreneur is given full power to run the project and is not restricted in terms of business activity, time, place or clients.

**Termination of Mudharaba**

- Some of the jurists are in view to allow mudharaba to be terminated if one of the two parties rescinds it, because it is an optional not a binding contract.
- Other jurists hold the view that mudharaba is binding and it cannot be rescinded if the mudharib commences work. Premature termination may disrupt business and harm at least one of the parties. This would be against the Shari’a spirit of mudharaba. I am with the view that once the project has started mudharaba contract is binding.
- In the case of the final settlement rabb-ul-mal recovers the mudharaba capital it contributed before dividing the profit between the two parties.
❖ If all assets are in cash form at the time of termination, and some profit has been earned on the principle amount, it shall be distributed between the parties according to the agreed ratio.
❖ However, if the assets are not in cash form, partners will be given the opportunity to sell or **liquidate** them, so that the actual profit may be determined.

**Areas of Application**
❖ *Mudharaba* facility is observed to be a useful mode for financing projects, such as, real estate and housing development, construction of public roads, ports, markets, buildings, plants, and other infrastructural concerns.
❖ *Mudharaba* is considered the essential mode accredited by the Islamic banks in their relationship with the depositors who tender their moneys to the bank as capital owners to be invested by the bank as *mudharib* on the basis of profit sharing according to specific ratios agreed upon.
❖ *Mudharaba* can be used with the investors who are capable to work whether they are physicians, engineers, IT specialists, or they are traders or craftsmen. The bank provides the adequate finance as a capital owner in exchange of a share in the profit to be agreed upon.
❖ It is also observed to be potentially quite promising in the field of microfinance or financing of small and medium enterprises.

**Importance of Mudharaba**
❖ *Mudharaba* has a major advantage over conventional banking since it provides a mode of financing that does not require collateral, which is only available to wealthy people.
❖ The use of *mudharaba* promotes distributive justice, and helps to alleviate concentration of wealth and income disparities via equitable reallocation of productive resources.
MUSHARAKA (PARTNERSHIP, JOINT VENTURE)

The Concept of Musharaka

✧ **Musharaka** is a joint venture partnership whereby two (or more) parties contribute to the capital and participate in the management to execute a potentially successful project with the purpose of earning *halal* profit, which will be shared among the partners.

✧ The capital of the company must be specific, existent and under disposal.

✧ It is not permissible to establish a company on non-existent fund or debt.

✧ The capital of the company must be money and valuables. However, some jurists permit participating with merchandise on condition it is evaluated in the contract and the agreed-upon value becomes part of the capital of the company.

✧ Partners may or may not have equal shares in the capital. Variations in shares is permissible and is subject to agreement.

✧ Once the partnership joint venture is set up, both parties jointly manage its operations, sharing the responsibilities as per pre-agreed terms.

✧ However, it is not obligatory for both parties to participate in management; but the party that manages the venture is allowed to have salary or higher share of profit.

✧ The Islamic banks mostly leave the responsibility of management to the partner, and retain the right of supervision and follow up.

✧ **Musharaka** is an ideal alternative to interest-based financing. It has a significant positive impact on both production and distribution in the economy.

✧ It is allowed for any of the partners to sell its share in the capital and withdraw from the project. **Musharaka** certificate represents proportionate ownership in assets of the partnership, and is a negotiable instrument. This is called securitization of **musharaka**

✧ **Musharaka** was supposed to be the basic mode of finance in the model of
interest-free banking. However, in modern Islamic banking, because of complexity and relatively high degree of risk, *Musharaka* financing is a rare practice and conducted only with well-established and reputed investors.

**Profit and Loss**

uada The return in a *musharaka* contract is based on the actual profit earned by the joint venture. Profit must not be a lump sum because this contravenes the requirement of partnership.

uada Profits of the venture will be shared between the parties according to the ratio of their capital invested in the business, or in any pre-agreed ratio.

uada Losses are always shared by partners strictly in proportion to capital contributions.

uada While the financier in a regular interest-bearing loan cannot suffer loss, the financier in *musharaka* can suffer loss.

uada If the investment has earned a loss in some transactions but has gained a profit in others, the profit shall be used to offset the loss at the first instance, and then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

**Liability**

uada *Musharaka* on the other hand, involves *unlimited liability* of the partners, as both are decision-makers in the business. Therefore, if the liabilities of the business exceed its assets and the business goes into liquidation, all the exceeding liabilities shall be borne proportionally by the partners.

**Types of Musharaka**

uada There are three main types of *musharaka* financing

1. **Permanent Musharaka (equity participation).**

uada In a permanent *Musharaka*, which is a form of equity participation, the
bank invests in partnership with the client, and continues to receive its share of the profits as long as the Musharaka continues.

2. Temporary Musharaka (working capital financing).
   ✷ A temporary Musharaka is a single transaction deal and is a form of working capital financing or seasonal financing.
   ✷ The bank invests for a short specified period, usually less than a year, and gets its share of the profits, as well as its investment, at the end of the agreed period.
   ✷ The temporary Musharaka may be renewed in the following year.

3. Diminishing (Decreasing) Musharaka (long-term financing).
   ✷ A diminishing musharaka is a partnership between financier and customer participate in joint ownership of property or commercial enterprise
   ✷ Share in ownership of financier divided into parts with the understanding that the customer will gradually purchase that share via periodic payments.
   ✷ The objective is for the customer to become the sole owner of the property or enterprise eventually
   ✷ Throughout the financing period, the financier, as joint owner, must share risks and liabilities associated with ownership
   ✷ Therefore, the financier's share in the equity declines each year through partial return of capital. The financier receives periodic profits based on its reduced equity share that remains invested during the period. The share of the client in the capital steadily increases over time, ultimately resulting in complete ownership of the venture. The profit share of the client goes to the financier as a repayment of the equity.
   ✷ The housing sector has witnessed greater use of diminishing musharaka than any other sector, since the expected profits from this business would be sourced from rentals that are predictable to a considerable degree.
Termination of Musharaka

✧ In a similar manner to a mudharaba contract, Some of the jurists are in view to allow musharaka to be terminated if one of the two parties rescinds it, because it is an optional not a binding contract.

✧ Other jurists hold the view that musharaka is binding and it cannot be rescinded if the work has been commenced. Premature termination may disrupt business and harm at least one of the parties. This would be against the Shari’a spirit of musharaka. I am with the view that once the project has started musharaka contract is binding.

✧ In the case of terminating the partnership, the assets may be liquidated prior to their distribution among the parties involved or the division could occur in asset format, depending on the preference of both parties.

✧ As in mudharaba, if assets are in cash form at the time of termination, and some profit has been earned on the principle amount, it shall be distributed between the parties according to the agreed ratio.

✧ However, if the assets are not in cash form, partners will be given the opportunity to sell or liquidate them, so that the actual profit may be determined.

Areas of Applications

✧ Musharaka (Partnership) is considered to be an appropriate mode of collective investment in modern economic life.

✧ Musharaka is suitable for financing any kind of business venture, manufacturing, trading, real estate, transportation, and others where the bank is willing to act as partner in the venture.

✧ A useful application of musharaka financing is the Islamic letter of credit.

✧ A survey of diminishing musharaka financing at various Islamic banks reveals that it is used primarily in the area of housing finance.

✧ Diminishing partnership is also suitable in financing industrial establishments, farms, and hospitals.
It is also observed to be potentially quite promising in the field of microfinance or financing of small and medium enterprises.

**Combination of Mudharaba-Musharaka**

- Sometimes *mudharaba* may be combined with *musharaka*.
- Like any other *musharaka* the client-entrepreneur contributes to the capital of the venture, as does the bank-financier.
- Like any other *mudharaba* the client-entrepreneur is solely responsible for the management of the business and the bank is purely a sleeping partner.
- The ratio of profit share for a pure financier (who does not participate in the management and operations of the business) cannot exceed the ratio of its contribution to capital of the venture.

**Addressing Apprehension towards Equity-Based Financing**

- Risk-sharing equity financing is not a common practice in the Islamic financial institutions. There are voices who argue that equity financing is too risky to be widely implemented by Islamic financial institutions. The following is their arguments and the responses of the advocates of the true implementations of the principles of Islamic finance

**1. Risk of Loss**

**Argument:**

- Financiers will bear losses, which will be passed on to depositors.
  
  Thus, Depositors will withdraw deposits from banks

**Advocated response**

- Prior to joining any investment project, a prudent and diligent analysis of business to which equity financing is made should be conducted
Banks must have a diversification strategy of equity financing portfolio

It is essential to remember that legitimate profit-taking is only comes with the undertaking of risk. Islamic financial institution cannot merely deal with money exchanges.

No complete separation between financing sector and the trade and industry sector

2. Dishonesty

Argument

Dishonest entrepreneurs will exploit equity-based instruments by under-declaring profits

Advocated response

Dishonesty can be avoided by proper controls, monitoring and auditing, as well as punitive measures against transgressors legislated to deter dishonesty, which should contain physical and monetary penalties, and defamation and denial of further financing facility.

3. Trade or business secrets

Argument

Entrepreneur or business operator has to disclose business secrets, which form the business’s competitive advantage, to the bank.

Advocated response

Confidentiality agreement between the entrepreneur and the bank can solve this problem. This agreement would involve severe penalties in the event of breach of that contract to maintain secrecy.
4. Unwillingness to Share Profits

Argument
✧ Profitable or capable entrepreneurs may not be willing to share profits with bank; they prefer conventional loans because returns to entrepreneur would be higher.
✧ Less competent entrepreneurs are more than willing to share business with bank because downside risk to their businesses would be minimized.
✧ Hence, banks will end up financing unprofitable ventures run by less competent entrepreneurs.

Advocated response
✧ It must be clear to Muslim investors that riba-based financing is sinful and not allowed; and thus, Muslim investor should not deal with interest-based lending institutions.
✧ The Islamic countries should make risk-sharing equity financing the only way to obtain financing.