

“MUSHARAKAH AND MUDARABAH AS MODES OF FINANCE”

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MUSHARAKAH AND MUDARABAH AS MODES OF FINANCING

The concept of *musharakah* and *mudarabah* envisaged in the books of Islamic *Fiqh* generally presumes that these contracts are meant for initiating a joint venture whereby all the partners participate in the business right from its inception and continue to be partners upto the end of the business when all the assets are liquidated. One can hardly find in the traditional books of Islamic *Fiqh* the concept of a running business where partners join and leave the enterprise without affecting in any way the continuity of the business. Obviously, the classical books of Islamic *Fiqh* were written in an environment where the large scale commercial enterprises were not in vogue and the commercial activities were not so complex as they are today. Therefore, they did not generally dwell upon the question of such a running business.

However, it does not mean that the concept of *musharakah* and *mudarabah* cannot be used for financing a running business. The concept of *musharakah* and *mudarabah* is based on some basic principles. As long as these principles are fully complied with, the details of their applications may vary from time to time. Let us have a look at these basic principles before entering the details:

1. Financing through *musharakah* and *mudarabah* does never mean the advancing of money. It means to participation in the business and in the case of *musharakah*, sharing in the assets of the business to the extent of the ratio of financing.
2. An investor/financier must share the loss incurred by the business to the extent of his financing.
3. The partners are at liberty to determine, with mutual consent, the ratio of profit allocated to each one of them, which may differ from the ratio of investment.

However, the partner who has expressly excluded himself from the responsibility of work for the business cannot claim more than the ratio of his investment.

4. The loss suffered by each partner must be exactly in the proportion of his investment.

Keeping these broad principles in view, we proceed to see how *musharakah* and *mudarabah* can be used in different sectors of financing:

Project Financing:

In the case of project financing, the traditional method of *musharakah* or *mudarabah* can be easily adopted. If the financier wants to finance the whole project, the form of *mudarabah* can come into operation. If investment comes from both sides, the form of *musharakah* can be adopted. In this case, if the management is the sole responsibility of one party, while the investment comes from both, a combination of *musharakah* and *mudarabah* can be brought into play according to the rules already discussed.

Since *musharakah* or *mudarabah* would have been effected from the very inception of the project, no problem with regard to the valuation of capital should arise. Similarly, the distribution of profits according to the normal accounting standards should not be difficult. However, if the financier wants to withdraw from the *musharakah*, while the other party wants to continue the business, the latter can purchase the share of the former at an agreed price. In this way the financier may get back the amount he has invested along with a profit, if the business has earned a profit. The basis for determining the price of his share shall be discussed in detail later on (while discussing the financing of the working capital).

On the other hand, the businessman can continue with his project, either on his own or by selling the first financier's share to some other person who can substitute the financier.

Since financial institutions do not normally want to remain partner of a specific project for good, they can sell their share to other partners of the project as aforesaid. If the sale of the share on one time basis is not feasible for the lack of liquidity in the project, the share of the financier can be divided into smaller units and each unit can be sold after a suitable interval. Whenever a unit is sold, the share of the financier in the project is reduced to that extent, and when all the units are sold, the financier comes out of the project totally.

Securitization of *Musharakah*:

Musharakah is a mode of financing which can be securitized easily, especially in the case of big projects where huge amounts are required which a limited number of people cannot afford to subscribe. Every subscriber can be given a *musharakah* certificate which represents his proportionate ownership in the assets of the *musharakah*, and after the project is started by acquiring substantial non-liquid assets, these *musharakah* certificates can be treated as negotiable instruments and can be bought and sold in the secondary market. However, trading in these certificates is not allowed when all the assets of the *musharakah* are still in liquid form (i.e., in the shape of cash or receivables or advances due from others).

For proper understanding of this point, it must be noted that subscribing to a *musharakah* is different from advancing a loan. A bond issued to evidence a loan has nothing to do with the actual business undertaken with the borrowed money.

The bond stands for a loan repayable to the holder in any case, and mostly with interest. The *musharakah* certificate, on the contrary, represents the direct pro rata ownership of the holder in the assets of the project. If all the assets of the joint project are in liquid form, the certificate will represent a certain proportion of money owned by the project. For example, one hundred certificates, having a value of Rs. one million each, have been issued. It means that the total worth of the project is Rs. 100 million. If nothing has been purchased by this money, every certificate will represent Rs. one million. In this case, this certificate cannot be sold in the market except at par value, because if one certificate is sold for more than Rs. one million, it will mean that Rs. one million are being sold in exchange for more than Rs. one million, which is not allowed in Shar'iah, because where money is exchanged for money, both must be equal. Any excess at their side is *riba*.

However, when the subscribed money is employed in purchasing non-liquid assets like land, building, machinery, raw material, furniture etc. the *musharakah* certificates will represent the holders' proportionate ownership in these assets .

Thus, in the above example, one certificate will stand for one hundred share in these assets. In this case it will be allowed by the Shari'iah to sell these certificates in the secondary market for any price agreed upon in between the parties which may be more than the fact value of the certificate, because the subject matter of the sale is a share in the tangible assets and not in the money only, therefore the certificate may be taken as any other commodities which may be sold with a profit or at a loss.

In most cases, the assets of the project are a mixture of liquid and non-liquid assets. This comes to happen when the working partner has converted a part of the subscribed money into fixed assets or raw material, while rest of the money is still liquid. Or, the project, after converting all it's money into non-liquid assets may have sold some of them and has acquired their sale proceeds in the form of money. In some cases the price of it's sales may have become due on it's customers but may have not yet been received. These receivable amounts, being a debt, are also treated as liquid money. The question arises about the rule of Shar'iah in a situation where the assets of the project are a mixture of liquid and non-liquid assets, whether the *musharakah* certificates of such a project can be traded in? The opinions of the contemporary Muslim jurists are different on this point. According to the traditional Shafi'i school, this type of certificate cannot be sold. Their classic view is that whenever there is a combination of liquid and non-liquid assets, it cannot be sold unless the non-liquid part of the business is separated and is sold independently.

The Hanafic school, however, is of the opinion that whenever there is a combination of liquid and non-liquid assets, it can be sold and purchased for an amount greater than the amount of liquid assets in the combination, in which case money will be taken as sold at an equal amount and the excess will be taken as the price of the non-liquid assets owned by the business.

Suppose, the *Musharakah* project contains 40% non-liquid assets i.e. machinery, fixtures, etc. and 60% liquid assets, i.e. cash, and receivables. Now, each *musharakah* certificate having the face value of Rs. 100/- represents Rs. 60/- worth of liquid assets, and Rs. 40 /- worth of non-liquid assets. This certificate may be sold at any price more than 60/-. If it is sold at Rs.110/- it will mean that Rs. 60/- of the price are against Rs. 60/- contained in the certificate and Rs. 50/- is against the proportionate share in the non-liquid assets. But it will never be allowed to sell the certificate for a price of Rs. 60/- or less, because in the case of Rs. 60/- it will not set the amount of Rs. 60/-, let alone the other assets.

According to the Hanafi view, no specific proportion of non-liquid assets in the whole is prescribed. Therefore, even if the non-liquid assets represent less than 50% in the whole, it's trading according to the above formula is allowed. However, most of the

contemporary scholars, including those of Shafi'i school have allowed trading in the units of the whole only if the non-liquid assets of the business are more than 50%.

Therefore, for a valid trading of the *musharakah* certificate acceptable to all schools, it is necessary that the portfolio of *Musharakah* consists of non-liquid assets valuing more than 50% of its total worth. However, if Hanafi view is adopted, trading will be allowed even if the non-liquid assets are less than 50%, but the size of the non-liquid assets should not be negligible.

Financing of a Single Transaction:

Musharakah and *mudarabah* can be used more easily for financing a single transaction. Apart from fulfilling the day-to-day needs of small traders, these instruments can be employed for financing imports and exports. An importer can approach a financier to finance him for that single transaction of import alone on the basis of *musharakah* or *mudarabah*. The banks can also use these instruments for import and financing. If the letter of credit has been opened without any margin, the form of *mudarabah* can be adopted, and if the L/C is opened with some margin, the form of *musharakah* or a combination of both will be relevant. After the imported goods are cleared from the port, their sales proceeds may be shared by the importer and the financier according to a preagreed ratio.

In this case the ownership of the imported goods shall remain with the financier to the extent of the ratio of his investment. This *musharakah* can be restricted to an agreed term, and if the imported goods are not sold in the market up to the expiry of the term, the importer may himself purchase the share of the financier, making himself the sole owner of the goods. However, the sale in this case should take place at the market rate or at a price agreed between the parties on the date of sale, and not at pre-agreed price at the time of entering into *musharakah*. If the price is pre-agreed, the financier cannot compel the client / importer to purchase it.

Similarly, *musharakah* will be even easier in the case of export financing. The exporter has a specific order from abroad. The price on which the goods will be exported is well-known before hand, and the financier can easily calculate the expected profit. He may finance him on the basis of *musharakah* and *mudarabah*, and may share the amount of export bill on a pre-agreed percentage. In order to secure himself from any negligence on the part of the exporter, the financier may put a condition that it will be the responsibility of the exporter to export the goods in full conformity with the conditions of the L/C. In this case, if some discrepancies are found, the exporter alone shall be responsible, and the financier shall be immune from any loss due to such discrepancies, because it is caused by the negligence of the exporter. However, being a partner of the exporter, the financier will be liable to bear any loss which may be caused due to any reason other than the negligence or misconduct of the exporter.

Financing of Working Capital:

Where finances are required for the working capital of a running business, the instrument of *musharakah* may be used in the following manner:

1. The capital of the running business may be evaluated with the mutual consent. It is already mentioned while discussing the traditional concept of *musharakah* that is not necessary, according to Imam Malik, that the capital of the *musharakah* is contributed in cash form. Non-liquid assets can also form part of the capital on the basis of evaluation. This view can be adopted here. In this way, the value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The *musharakah* may be effected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier which should not exceed the percentage of his investment, because he shall not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated and the profit may be distributed on the basis of this evaluation.

Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as “constructive liquidation” with mutual consent of the parties, because there is no specific prohibition in Shar’iah against it. It can also mean that the working partner has purchased the share of the financier in the assets of his business, and the price of his share can be determined on the basis of valuation, keeping in view the ratio of the profit allocated for him according to the terms of the *musharakah*. For example, the total business of the value of A is 30 units. B finances another 20 units, raising the total worth to 50 units; 40% having been contributed by B, and 60% by A. It is agreed that B shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased 100 units.

Now, if the share of B is purchased by A, he should have paid to him 40 units, because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit.

Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20-80, meaning thereby that 10 units will have been earned by B. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by B (being 40% of the loss.) These 4 units shall be deducted from its original 20 units, and the price of his share shall be determined as 16 units.

Sharing in the Gross Profit Only:

2. Financing on the basis of *musharakah* according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, *musharakah* may be applied in another way.

The major difficulties in these cases arise in the calculation of indirect expenses, like the depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses shall not be deducted from the distributable profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labour, electricity etc.) shall be borne by the *musharakah*. But since the industrialist is offering his machinery, building and staff to the *musharakah* voluntarily, the percentage of his profit may be increased to compensate him to some extent.

This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to *musharakah*, and in such a case the whole cost of these expenses cannot be imposed on the *musharakah*.

Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000/- per month. The factory sought finance of Rs. 5,000,000/- from a bank on the basis of *musharakah* for a term of one year. It means that after one year the *musharakah* will be terminated, and the profits accrued up to that point will be distributed between parties according to the agreed ratio.

While determining the profit, all direct expenses will be deducted from the income. The direct expenses may include the following:

- (i) The amount spent on purchasing raw material.
- (ii) The wages of the labour directly involved in processing the raw material.
- (iii) The expenses for electricity consumed in the process of ginning.
- (iv) The bills for other services directly rendered for the *musharakah*.

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of *musharakah* alone, because the *musharakah* will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year *musharakah*. Therefore, the whole cost of the building and the machinery cannot be borne by this short-term *musharakah*.

What can be done at the most is that the depreciation caused to the building and the machinery during the term of the *musharakah* is included in its expenses. But in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the *musharakah* portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the *musharakah* fund irrespective of profit or loss accruing to the business.

The second opinion is that, instead of paying rent to the client, the ratio of his profit is increased. From the point of view of Shar'iah, it may be justified on the analogy of *mudarabah* in services which is allowed in the view of Imam Ahmad bin Hanbal.

Running Musharakah Accounts on the Basis of Daily Products:

3. Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Can such an arrangement be possible under the *musharakah* or *mudarabah* modes of financing? Obviously, being a new phenomenon, no express answer to this question can be found in the classical works of Islamic *Fiqh*.

However, keeping in view the basic principles of the *musharakah* the following procedure may be suggested for this purpose:

- i. A certain percentage of the actual profit must be allocated for the management.
- ii. The remaining percentage of the profit must be allocated for the investors.
- iii. The loss, if any, should be borne by the investors only in exact proportion of their respective investments.
- iv. The average balance of the contributions made to the *musharakah* account calculated on the basis of daily products shall be treated as the share capital of the financier.
- v. The profit accruing at the end of the term shall be calculated on daily product basis and shall be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principles of the *musharakah*. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the *musharakah* portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the amount of the days each investor has put his money into the business, which will determine his profit entitlement on the daily product basis.

Some contemporary scholars do not allow this method of calculating profits on the ground that it is just a conjectural method which does not reflect the actual profits really earned by a partner of the *musharakah*, because the business may have earned huge profits during a period when a particular investor had no money invested in the business at all, or had a very negligible amount invested, still, he will be treated at par with other investors who had huge amounts invested in the business during that period. Conversely, the business may have suffered a great loss during a period when a particular investor had huge amounts invested in it. Still, he will pass on some of his loss to other investors who had no investment in that period or their size of investment was negligible.

This argument can be refuted on the ground that it is not necessary in a *musharakah* that a partner should earn profit on his own money only. Once a *musharakah* pool comes into existence, the profits accruing to the joint pool are earned by all the participants, regardless of whether their money is or is not utilized in a particular transaction. This is particularly true of a Hanafi School which does not deem it necessary for a valid *musharakah* that the monetary contributions of the partners are mixed up together. It means that if A has entered into a *musharakah* contract with B, but has not yet disbursed his money into the joint pool, he will still be entitled to a share in the profit of the transactions effected by B for the *musharakah* through his own money. Although his entitlement to a share in the profit will be subject to the disbursement of money undertaken by him, yet the fact remains that the profit of this particular transaction did not accrue to his money, because the money disbursed by him at a later stage may be used for another transaction. Suppose, A and B entered into a *musharakah* to conduct a business of Rs. 100,000/- They agreed that each of them shall contribute Rs. 50,000/- and the profits will be distributed by them equally. A did not yet invest his Rs. 50,000/- into the joint pool. B found a profitable deal and purchased two air conditioners for the *musharakah* for Rs. 50,000/- contributed by himself and sold them for Rs. 60,000/-, thus earning a profit of Rs. 10,000/-. A contributed his share of Rs. 50,000/- after this deal.

The partners purchased two refrigerators through this contribution which could not be sold at a greater price than Rs. 48,000/- meaning thereby this deal resulted in a loss of Rs. 2,000/- Although the transactions effected by A's money brought a loss of Rs.2,000/- while the profitable deal of air conditioners was financed entirely by B's money in which A had no contribution, yet A will be entitled to a share in the profit of the first deal. The loss of Rs.2,000/- in the second deal will be set off from the profit of the first deal reducing the aggregate profit to Rs. 8,000/-. This profit of Rs.8,000/- will be shared by both partners equally. It means that A will get Rs. 4,000/-, even though the transaction effected by his money has suffered loss.

The reason is that once a *musharakah* contract is entered into by the parties, all the subsequent transactions effected for *musharakah* belong to the joint pool, regardless of whose individual money is utilized in them. Each partner is a party to each transaction by virtue of his entering into the contract of *musharakah*.

A possible objection to the above explanation may be that in the above example, A had undertaken to pay Rs. 50,000/- and it was known before hand that he will contribute a

specified amount to the *musharakah*. But in the proposed running account of the *musharakah* where the partners are coming in and going out everyday, nobody has undertaken to contribute any specific amount. Therefore, the capital contributed by each partner is unknown at the time of entering into *musharakah*, which should render the *musharakah* invalid.

The answer to the above objection is that the classical scholars of Islamic *Fiqh* have different views about whether it is necessary for a valid *musharakah* that the capital is pre-known to the partners. The Hanafi scholars are unanimous on the point that it is not a pre-condition. Al- Kassani, the famous Hanafi jurist, writes:

“According to our Hanafi School, it is not a condition for the validity of the musharakah that the amount of capital is known, while it is a condition according to Imam Shafi’i. Our argument is that Jahalah (uncertainty) in it self does not render a contract invalid, unless it leads to disputes. And the uncertainty in the capital at the time of musharakah does not lead to disputes, because it is generally known when the commodities are purchased for the musharakah, therefore it does not lead to uncertainty in the profit at the time of distribution.”

It is, therefore, clear from the above that even if the amount of the capital is not known at the time of *musharakah*, the contract is valid. The only condition is that it should not lead to the uncertainty in the profit at the time of distribution. Distribution of profit on daily product basis fulfills this condition.

It is true that the concept of a running *musharakah* where the partners at times draw some amounts and at other times inject new money and the profits are calculated on daily product basis is not found in the classical books of Islamic *Fiqh*. But merely this fact cannot render a new arrangement invalid in Shar’iah, so far as it does not violate any basic principle of *musharakah*. In the proposed system, all the partners are treated at par. The profit of each partner is calculated on the basis of the period for which his money remained in the joint pool. There is no doubt in the fact that the aggregate profits accrued to the pool are generated by the joint utilizations of different amounts contributed by the participants at different times. Therefore if all of them agree with mutual consent to distribute the profits on a daily basis, there is no injunction of the Shar’iah which makes it impermissible; rather it is covered under the general guide line given by the Holy Prophet (PBUH) in his famous hadith quoted in this book more than once:

“Muslims are bound by their mutual agreement unless they hold a permissible thing as prohibited or a prohibited thing as permissible.”

If distribution on daily products basis is not accepted, it will mean that no partner can draw any amount from, nor can he inject new amounts to the joint pool. Similarly, nobody will be able to subscribe to the joint pool except at the particular dates of the commencement of a new term. This arrangement is totally impracticable on the deposit sides of the banks and financial institutions where the accounts are debited and credited by the depositors many times a day. The rejection of the concept of the daily products

will compel them to wait for months before they deposit their surplus money in a profitable account. This will hinder the utilization of savings for development of industry and trade, and will keep the wheel of financial activities jammed for long periods. There is no other solution for this problem except to apply the method of daily products for the calculation of profits, and since there is no specific injunction of Shar'iah against it, there is no reason why this method should not be adopted.

Some Objections on *Musharakah* Financing:

Let us now examine some objections raised from practical point of view against using *musharakah* as a mode of financing.

1. Risk of Loss:

It is argued that the arrangement of *musharakah* is more likely to pass on losses of the business to the financier bank or institution. This loss will be passed on to depositors also. The depositors, being constantly exposed to the risk of loss, will not want to deposit their money in the banks and financial institutions and thus their savings will either remain idle or will be used in transactions outside of the banking channels, which will not contribute to the economic development at national level.

This argument is, however, misconceived. Before financing on the basis of *musharakah*, the banks and financial institutions will study the feasibility of the proposed business for which funds are needed. Even in the present system of the interest-based loans and the banks do not advance loans to each and every applicant. They study the potentials of the business and if they apprehend that the business is not profitable, they refuse to advance a loan.

In the case of *musharakah*, they will have to carry out this study with more depth and precaution. Moreover, no bank or financial institution can restrict it self to a single *musharakah*. There will always be a diversified portfolio of *musharakah*. If a bank has financed 100 of its clients on the basis of *musharakah*, after studying the feasibility of the proposal of each one of them, it is hardly conceivable that all of these *musharakahs*, or the majority of them will result in a loss. After taking proper measures and due care, what can happen at the most is that some of them make a loss. But on the other hand, the profitable *musharakahs* are expected to give more return than the interest-based loans, because the actual profit is supposed to be distributed between the client and the bank.

Therefore, the *musharakah* portfolio, as a whole, is not expected to suffer loss, and the possibility of loss to the whole portfolio is merely a theoretical possibility which should not discourage the depositors. This theoretical possibility of loss in a financial institution is much less than the possibility of loss in a joint stock company whose business is restricted to a limited sector of commercial activities. Still the people purchase its shares and the possibility of loss does not refrain them from investing in these shares. The case of the bank and financial institutions is much stronger, because their *musharakah* activities will be so diversified that any possible loss in one *musharakah* will be more than compensated by the profits earned in other *musharakahs*.

Apart from this, an Islamic economy must create a mentality which believes that any profit earned on money is a reward of bearing risks of the business. This risk may be minimized through expertise and diversifying a portfolio where it becomes a hypothetical or theoretical risk only. But there is no way to eliminate this risk totally. The one who wants to earn profit, must accept this minimal risk. Since this understanding is already there in the case of normal joint stock companies, nobody has ever raised the objection that the money of the shareholders is exposed to loss.

The problem is created by the system which separates the banking and financing from the normal trade activities, which has compelled the people to believe that the banks and financial institutions deal in money and papers only, and that they have nothing to do with the actual results emerging in trade and industry. Therefore, it is argued that they deserve a fixed return in any case. This separation of financing sector from the sector of trade and industry has brought great harms to the economy at macro-level.

Obviously, when we speak of Islamic banking, we never mean that it will follow this conventional system in each and every respect. Islam has its own values and principles which do not believe in separation of financing from trade and industry. Once this Islamic system is understood, the people will invest in the financing sector despite the theoretical risk of loss, more readily than invest in the profitable joint stock companies.

2. Dishonesty:

Another apprehension against *musharakah* financing is that the dishonest clients may exploit the instrument of *musharakah* by not paying any return to the financiers. They can always show that the business did not earn any profit. Indeed, they can claim that it has suffered a loss in which case not only the profit but also the principle amount will be jeopardized.

It is, no doubt, a valid apprehension, especially in societies where corruption is the order of the day. However, solution to this problem is not as difficult as is generally believed or exaggerated.

If all the banks in a country are run on pure Islamic pattern with a careful support from the Central Bank and the government, the problem of dishonesty is not hard to overcome. First of all, a well designed system of auditing should be implemented whereby the accounts of all the clients are fully maintained and properly controlled. It is already discussed that the profits may be calculated to the basis of gross margins only. It will reduce the possibility of disputes and misappropriation. However if any misconduct, dishonesty or negligence is established against a client, he will be subject to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specified period.

These steps will serve as strong deterrent against concealing the actual profit or committing any other act of dishonesty. Otherwise, also the clients of the banks cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a

possibility of some cases where dishonest clients may succeed in their evil designs, but the punitive steps and the general atmosphere of the business will gradually reduce the number of such cases (Even in an interest-based economy, the defaulters have always been creating the problem of bad debts) But, it should not be taken as a justification, or as an excuse, for rejecting the whole system of *musharakah*.

Undoubtedly, the apprehension of dishonesty is more severe for Islamic Banks and financial institutions working in isolation from the main stream of conventional banks. They have not much support from their respective governments and central Banks. They cannot change the system, nor can they impose their own laws and regulations. However, they should not forget that they are not just commercial institutions. They have been established to introduce a new system of banking which has its own philosophy. They are duty bound to promote this new system, even if they apprehend that it would reduce the size of their profits to some extent. Therefore, they should start using the instrument of *musharakah*, at least on a selective basis. Each and every bank has a number of clients whose integrity is beyond all doubts. The Islamic banks, should at least, start financing them on the basis of true *musharakah*. It will help setting good precedents in the market and induce others to follow suit. Moreover, there are some sectors of financing where *musharakah* can be used easily. For example, the use of *musharakah* instrument in financing exports has not much room for dishonesty. The exporter has the specific order from abroad. The prices are agreed. The costs are not difficult to determine. Payments are normally secured by a letter of credit. The payments are made through the bank itself.

There is no reason in such cases why the *musharakah* arrangement should not be adopted. Similarly, financing of imports may also be designed on the basis of *musharakah* with some precautions, as explained earlier.

3. Secrecy of the Business:

Another criticism against *musharakah* is that, by making the financier a partner in the business of the client, it may disclose the secrets of the business to the financier, and through him to other traders.

However, the solution to this problem is very easy. The client, while entering into the *musharakah*, may put a condition that the financier will not interfere with the management affairs, and he will not disclose any information about the business to any person without prior permission of the client. Such agreements of maintaining secrecy are always honored by the prestigious institutions, especially by the bank and financial institutions whose entire business is based on confidentiality.

4. Client's Unwillingness to Share Profits:

Many a time, it is mentioned that the clients are not willing to share with the banks the actual profits of their business. The reluctance is based on two reasons:

They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why should they (the clients) share the fruit of their labour with the Bank

who merely provides funds. The Clients also argue that conventional banks are content with a meagre rate of interest and so should be the Islamic Banks.

Even if the above was not a factor, the Clients are afraid to reveal their true profits to the Banks, lest the information is also passed on to the tax authorities and Clients' tax liability increases.

The solution to the first part, though not easy, is not difficult or impossible either. Such clients need to be convinced and persuaded that borrowing on interest is a cardinal sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need, by any stretch of imagination.

By making a legitimate arrangement for obtaining funds for their business, by way of *Musharakah*, not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

In respect of the second factor, all that can be said is that in some Muslim countries, rate of taxation are indeed prohibited and unjust. Islamic Banks as well as their Clients must lobby with the governments and struggle to change the laws which hamper the progress towards Islamic banking. The governments should also try to appreciate the fact that if rates of taxation are reasonable and if tax-payers are convinced that they will benefit by honestly paying their taxes, this would increase, and not decrease, government revenues.

Diminishing *Musharakah*:

Another form of *Musharakah*, developed in the near past, is 'Diminishing *Musharakah*'. According to this concept, a financier and his client participate either in the joint ownership of a property or an equipment, or in a joint commercial enterprise. The share of the financier is further divided into a number of units and it's understood that the client will purchase the units of the share of the financier one by one periodically, thus increasing his own share till all the units of the financier are purchased by him so as to make him the sole owner of the property, or the commercial enterprise, as the case may be.

The diminishing *Musharakah* based on the above concept and has taken different shapes in different transactions. Some examples are given below:

1. It has been used mostly in house financing. The client wants to purchase the house for which he does not have adequate funds. He approaches the financier who agrees to participate with him in purchasing the required house. 20% of the price is paid by the client and 80% of the price by the financier. Thus the financier owns 80% of the house while the client owns 20%. After purchasing the property jointly, the client uses the house for his residential requirement and pays rent to the financier for using his share in the property. At the same time the share of the financier is further divided in eight equal units, each unit representing 10% ownership of the house. The client promises to the financier that he will purchase one unit after three months. Accordingly, after the first term of three months he purchases one unit of the share of the

financier by paying 1/10th of the price of the house. It reduces the share of the financier from 80% to 70%.

Hence, the rent payable to the financier is also reduced to that extent. At the end of the second term, he purchases another unit increasing his share in property to 40% and reducing the share of the financier to 60% and consequentially reducing the rent to that proportion. This process goes on in the same fashion until after the end of the two years, the client purchases the whole share of the financier reducing the share of the financier to 'zero' and increasing his own share to 100%.

This arrangement allows the financier to claim rent according to his proportion of ownership in the property at the same time allows him periodical return of a part of his principle through the purchases of the units of his share.

2. 'A' wants to purchase a taxi to use it for offering transport services to passengers and to earn the income through fares recovered from them but he is short of funds. 'B' agrees to participate in the purchase of the taxi, therefore, both of them purchase a taxi jointly. 80% of the price is paid by 'B' and 20% is paid by 'A'. After the taxi is purchased, it is employed to provide transport to the passengers where by the net income of Rs. 1000/- is earned on daily basis. Since 'B' has 80% share in the taxi it is agreed that 80% of the fare will be given to him and the rest of the 20% will be retained by 'A' who has 20% share in the taxi. It means that Rs. 800/- is earned by 'B' and Rs. 200 by 'A' on a daily basis. At the same time the share of 'B' is further divided into eight units. After three months 'A' purchases one unit from the share of 'B'. Consequently the share of 'B' is reduced to 70% and the share of 'A' is increased to 30% meaning thereby that as from the date 'A' will be entitled to Rs. 300/- from the daily income of the taxi and 'B' will earn Rs. 700/-.

This process will go on until after the expiry of two years, the whole taxi will be owned by 'A' and 'B' will take back his original investment along with income distributed to him as aforesaid.

3. 'A' wishes to start the business of ready-made garments but lacks the required fund for that business. 'B' agrees to participate with him for a specified period, say two years. 40% of the investment is contributed by 'A' and 60% by 'B'. Both start the business on the basis of the *Musharakah*. The proportion of the profit allocated for each one of them is expressly agreed upon. But at the same time 'B's share in the business is divided into six equal units and 'A' keeps purchasing these units on gradual basis until after the end of the two years 'B' comes out of the business, leaving it's exclusive ownership to 'A'. Apart from periodical profits earned by 'B', he gains the price of the units of his share which, in practical terms, tend to repay him the original amount invested by him.

Analyzed from the Shar'iah point of view this arrangement is composed of different transactions which come to pay their role at different stages. Therefore, each one of the foregoing three forms of diminishing Musharakah is discussed below in the light of the Islamic principles:

House Financing on the Basis of Diminishing *Musharakah*:

The proposed arrangement is composed of the following transactions:

1. To create joint ownership in the property (*Shirkat-ul-Milk*).
2. Giving the share of the financier to the client on rent.
3. Promise from the client to purchase the units of share of the financier.
4. Actual purchase of the units at different stages.
5. Adjustment of the rental according to the remaining share of the financier in the property.

Let me discuss each ingredient of the arrangement in a greater detail:

(i) The first step in above arrangement is to create a joint ownership in the property. It has already been explained in the beginning of the chapter that '*Shirkat-ul-Milk*' (joint ownership) can come into existence in different ways including joint purchase by the parties. This has been expressly allowed by all schools of Islamic jurisprudence. Therefore no objection can be raised against creating this joint ownership.

(ii) The second part of this arrangement is that the financier leases his share in the house to his client and charges rent from him. This arrangement is also above board because there is no difference of opinion among the Muslim jurists in the permissibility of leasing one's undivided share in a property to his partner. If the undivided share is leased out to a third party, its permissibility is a point of difference between the Muslim jurists. Imam Abu Hanifa and Imam Zuhri are of the view that the undivided share cannot be leased out to a third party while Imam Malik and Imam Shafi'i, Abu Yusuf and Mohammed Ibn Hasan hold that the undivided share can be leased out to any person. But so far as the property is leased to the partner himself all of them are unanimous on the validity of '*Ijarah*'.

(iii) The third step in the aforesaid arrangement is that the client purchases different units of the undivided share of the financier. This transaction is also allowed. If the undivided share relates to both land and building, the sale of both is allowed according to all the Islamic schools. Similarly if the undivided share of the building is intended to be sold to the partner, it is also allowed unanimously by all the Muslim jurists. However, there is a difference of opinion if it is sold to the third party.

It is clear from the foregoing three points that each one of the transactions mentioned here and above is allowed per se, but the question is whether this transaction may be combined in a single arrangement. The answer is if all these transactions have been combined by making each of them a condition to the other, then this is not allowed in the Shar'iah, because it is a well settled rule in the Islamic legal system that one transaction cannot be made a pre-condition for another. However, the proposed scheme suggests that instead of making two transactions conditional to each other, there should be one sided promise from the client, firstly, to take the share of the financier on lease and pay the agreed rent, and secondly, to purchase different units of the share of the financier of the

house at different stages. This leads us to the forth issue, which is, the enforceability of such a promise.

(iv) It is generally believed that a promise to do something creates only a moral obligation on the promisor which cannot be enforced through courts of law. However, there are a number of Muslim jurists who opine that promises are enforceable, and the court of law can compel the promisor to fulfill his promise, especially, in the context of commercial activities. Some Maliki and Hanifi jurists can be cited in particular, in particular, who have declared that promises can be enforced through the courts of law in cases of need. The Hanifi jurists have adopted this view with regard to a particular sale called '*bai-bilwafa*'.

This '*bai-bilwafa*' is a special arrangement of sale of a house whereby the buyer promises to the seller that whenever the latter gives him back the price of the house, he will resell the house to him. This arrangement was in vogue in countries of central Asia, and the Hanafi jurists have opined that if the resale of the house to the original seller is made a condition for the initial sale, it is not allowed. However, if the first sale is effected without any condition, but after effecting the sale, the buyer promises to resell the house whenever the seller offers to him the same price, this promise is acceptable and it creates not only a moral obligation, but also an enforceable right of the original seller. The Muslim jurists allowing this arrangement have based their view on the principle that (the promise can be made enforceable at time of need).

Even if the promise has been made before effecting the first sale, after which the sale has been affected without a condition, it is also allowed without certain Hanafi jurists.

One may raise an objection that if the promise of resale has been taken before entering into an actual sale, it practically amounts to putting a condition on the sale itself, because the promise is understood to have been entered into between the parties at the time of sale, and therefore, even if the sale is without an express condition, it should be taken as conditional because a promise in an express term has preceded it.

This objection can be answered by saying that there is a big difference between putting a condition in the sale and making a separate promise by making it a condition. If the condition is expressly mentioned at the time of sale, it means that the sale will be valid only if the condition is fulfilled, meaning thereby that if the condition is not fulfilled in future, the present sale will become void. This makes the transaction of the sale contingent on a future event which may or may not occur. It leads to uncertainty (*Gharar*) in the transaction which is totally prohibited in Shar'iah.

Conversely, if the sale is without any condition, but one of the two parties has promised to do something separately, then the sale cannot be held contingent or conditional with fulfilling of the promise made. It will take effect irrespective of whether or not the promisor fulfills his promise. Even if the promisor backs out of his promise, the sale will remain effective. The most the promisee can do is to compel the promisor through court

of law to fulfill his promise and if the promisor is unable to fulfill the promise, the promisee can claim actual damages he has suffered because of the default.

This makes it clear that a separate and independent promise to purchase does not render the original contract conditional or contingent. Therefore, it can be enforced. On the basis of this analysis, diminishing the *Musharakah* may be used for Housing Finance with following conditions:

(a) The agreement of joint purchase, leasing and selling different units of the share of the financier should not be tied-up together in one single contract.

However, the joint purchase and the contract of lease may be joined in one document whereby the financier agrees to lease his share, after joint purchase, to the client. This is allowed because, as explained in the relevant chapter, *Ijarah* can be effected for a future date. At the same time the client may sign one-sided promise to purchase different units of the share of the financier periodically and the financier may undertake that when the client will purchase a unit of his share, the rent of the remaining units will be reduced accordingly.

(b) At the time of the purchase of each unit, sale must be effected by the exchange of offer and acceptance at that particular date.

(c) It will be preferable that the purchase of different units by the client is effected on the basis of the market value of the house as prevalent on the date of purchase of that unit, but it is also permissible that a particular price is agreed in the promise of purchase signed by the client.

Diminishing *Musharakah* for Carrying Business of Services:

The second example given above for diminishing *Musharakah* is the joint purchase of a taxi run for earning income by using it as a hired vehicle. This arrangement consists of the following ingredients:

(i) Creating joint ownership in a taxi in the form of *Shirkat-ul-Milk*. As already stated this is allowed in Shar'iah.

(ii) *Musharakah* is the income generated through the services of taxi. It is also allowed as mentioned earlier in this chapter.

(iii) Purchase of different units of the share of the financier by the client. This is again subject to the conditions already detailed in the case of House financing. However, there is a slight difference between the House financing and the arrangement suggested in this second example. The taxi, when used as a hired vehicle, normally depreciates in value overtime, therefore, depreciation in the value of taxi must be kept in mind while determining the price of different units of the share of the financier.

Diminishing *Musharakah* in Trade:

The third example of diminishing *Musharakah* as given above is that the financier contributes 60% of the capital for launching a business of ready made garments, for example. This arrangement is composed of two ingredients only:

1. In the first place, the arrangement is simply a *Musharakah* whereby two partners invest different amounts of capital in a joint enterprise. This is obviously permissible subject to the conditions of *Musharakah* already spelled out earlier in this chapter.
2. Purchase of different units of the share of the financier by the client. This may be in the form of a separate and independent promise by the client. The requirements of Shar'iah regarding this promise are the same as explained in the case of House financing with one very important difference. Here the price of units of the financier cannot be fixed in the promise to purchase, because if the price is fixed before hand at the time of entering the *Musharakah*, it will practically mean that the client has ensured the principle invested by the financier with or without profit, which is strictly prohibited in the case of *Musharakah*.

Therefore, there are two options for the financier about fixing the price of his units to be purchased by the client. One option is that he agrees to sell the units of the basis of valuation of the business at the time of the purchase of each unit. If the value of the business has increased, the price will be higher and if it is decreased the price would be less. Such valuation may be carried out in accordance with the recognized principles through the experts, whose identity may be agreed upon between the parties when the promise is signed. The second option is that the financier allows the client to sell these units to any body else at whatever price he can, but at the same time he offers a specific price to the client, meaning thereby that if he finds a purchaser of that unit at a higher price, he may sell it to him, but if he wants to sell it to the financier, the latter will be agreeable to purchase it at a price fixed by him before hand.

Although both these options are available according to the principles of the Shar'iah, the second option does not seem to be feasible for the financier, because it would lead to injecting new partners in the *Musharakah* which will disturb the whole arrangement and defeat the purpose of diminishing *Musharakah* in which the financier wants to get his money back within a specified period. Therefore, in order to implement the objective of diminishing *Musharakah*, only the first option is practical.