Equity Financing Models in Islamic Finance: Efficacy and Limitations

- Zubair Hamid

Abstract

Islamic finance has emerged to create a possibility of merchandise within the approved models and practical considerations of the Shariah compliants. Islamic finance has emerged as an alternative in the contemporary corporate sector as the Muslims have been trying to reconstruct their socio-economic institutions on the basis of Islamic principles. Islamic finance being totally different from conventional banking , does not affirm its foundation on the cardinal principles of interest. Interest-free system and equity based contracts (PLS) is definitely an alternative resource for inclusion in the interest-free financial management, as Islamic finance refrains completely from interest (usury) and thrusts on profit and loss sharing (PLS). Islamic finance operates in the real economy and is broadly structured around the concept of trade. It is constructed upon the principles of akhuwah (brotherhood) and ta'awun (cooperation) and stands for equity sharing between investor and the entrepreneur. Equity financing is regarded as the heart and soul of Islamic finance. Equity financing in Islam stands against speculation, unjust enrichment, interest and uncertainty. Equity financing employs various contracts like Mudarabah, Musharakah, Ijarah, Wadiyah, Sukuk, etc. but this paper will only discuss Mudarabah and Musharakah and their viability, efficacy and limitations in the Islamic financial sector.

Key Words: Mudarabah, Musharakah, Islamic Finance, Equity

General Equity

Equity refers to the residual value of a company's assets after all outside liabilities (other than to shareholders) have been allowed for. According to A.W. Stonier and D.C. Hague, "equity means security which does not yield a fixed and known amount of interest each year". The term equity adverts to an ordinary share of a joint stock company. The equity of a company is the value of the net asset represented by the ordinary shares. In public finance equity refers to justice.[1] There are three types of equity: distributional equity, horizontal equity and vertical equity.[2]

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[1] N.B. Ghodke, *Encyclopedia Dictionary of Economics,* vol.2, Mittal publications, New Delhi, 1985, p. 401.
[2] David W. Pearce (ed.), *Macmillan Dictionary of Modern Economics,* Edition IV, Palgrave Macmillan, 1981, pp.111, 188, 450.

Equity Financing in Islam

Islamic finance is a safe financial doctrine that promises justice and equity. The theme of Islamic finance is popular among those economies that are either interested in following the Shariah tenets or are exploring alternative investment opportunities that have a sound basis and a promising potential. The principles of Islamic finance fundamentally uphold the corporate governance and social responsibility philosophies: that is, accountability, transparency and equitable distribution of wealth. They are derived from the Shariah and financial laws enabled by the Quran. The stipulations of the Quran pertaining to the economic and financial system are for the benefit of all mankind. Islamic finance is a subject that has reached out to a reasonable number of Muslims, as well as non-Muslims and financial planners and is now accepted as an international form of financial intermediation. The practitioners and scholars of Islamic finance are expected to devise an unprejudiced approach for the purpose. The role of Islamic financial institutions and Islamic regulatory organizations is critical in promoting an ethical based financial system to provide the solution for the ailing conventional financial system. Islamic finance is totally based on the equity financing.[3]

Features: the main features upon which Islamic finance (equity financing) is based are;

1. Speculation: Contracts which involve speculation (*maysir*) are not permissible (*haram*) and are considered void. Islamic law does not prohibit general commercial speculation, but it does prohibit speculation which is akin to gambling i.e. gaining something by chance rather than productive effort.
2. Unjust enrichment: contracts where one party gains unjustly at the expense of another are considered void.
3. Interest: The payment and receipt of interest are prohibited and any obligation to pay interest is considered void. Islamic principles require that any return on funds provided by the lender be earned by way of profit derived from a commercial risk taken by that lender.
4. Uncertainty : Contracts which contain uncertainty (*gharar*) particularly when there is uncertainty as to the fundamental terms of the contract, such as the subject matter, price and time for delivery are considered void.[4]

[3] Bilal Rasul, "Islamic Finance and the Global Financial Crisis", *Islamic Finance Instruments and Markets*, p. 119.
[4] Qudeer Lateef & Susi Crawford, "Introduction to Islamic Financial Risk Management Products", *Islamic Finance Instruments and Markets*, n.d. p. 11.

The strength and power of a society depends on its social interdependence, to fulfill the needs of its own people. Hence it is indispensable to pool the resources from where they are available to fulfill the needs of the society.[5]Muslims must be cooperative and share their tears and joys with one another. The Quran Says:

Help ye one another In righteousness and piety, but help ye not one another In sin and rancor: fear Allah for Allah is strict In punishment.[6]

The Quran also states that the purpose of its revelation is to establish justice and equity.[7] Based on this principle Islam presents profit and loss sharing in an equitable manner in the finance where profit and loss is shared by the partners equitably. In Islamic finance there are alternatives to interest based lending such as *Qard al Hassan* and equity financing.[8] Equity finance means putting money in a regulated structured security with an expectation of reasonable gains through over a period of time, and a higher security for the principle amount.[9] In equity finance the financier shares in the profit or loss of the business financing. So as to not only distribute equitably the return on total investment between the partners, but to transfer a fair sharing of the risks of the investment to the financier instead of putting the whole burden on the entrepreneur.[10] In Islamic economy equity finance has to be for either an indefinite period or a definite (short, medium or long) period as it is in the case of borrowed capital (loans, advances, bonus, etc). It would be difficult to find medium or long term financing in an Islamic economy without sharing the ownership and control of the business.[11] Equity investment differs from conventional investment on selection of businesses one invests in; it prohibits investment in businesses of Liquor, Tobacco, pork, interest-based banking etc. The strength of Islamic investment actually that it is ethically and socially responsible in nature. Hence there is a moral commitment and performance.[12] Equity investment is a better and viable option availab`le to Muslims because it is the solution for them particularly for the working class and the self employed group.[13] In equity financing the amounts are invested in the shares of joint stock companies the profit are mainly derived through the capital gains by purchasing the shares and selling them when their prices are

[5] Umer chapra , *Towards a just Monetary system*, The Islamic Foundation, U.K., 1985, p.67
[6]Al-Quran (5:2)
[7] Dr. Mushtaq Ahmad, *Business Ethics in Islam,* Kitab Bhawan, New Delhi, 1999, p. 82.
7.Umer Chapra, *Op.Cit.*, p. 68.
[9] Islami Tijara, Equity Investment: A Viable Option for Muslims, Oct.2012, p.19.
[10] Umer Chapra,*Op.Cit.,* p.68
[11]Jaquir Iqbal, *Islamic Finance Management*, Global Vision Publishing House, New Delhi, pp. 193-194.
[12] Islami Tijara, oct. 2012, p.19.
[13]*Idem*.

increased. It is obvious that if the main business of a company is unlawful in terms of *shariah,* it is not allowed in Islamic fund to purchase it, hold it or sell its shares, as it will entail the direct involvement of the shareholder in that prohibited business.[14] Equity financing can help on reducing substantially the indiscriminate lending to the private sector or to governments i.e. often undertaken by banks when they have an assurance of return of their principle with interest.[15] This type of finance is an exchange of money (from a lender) for a piece of ownership in the business. This appears to be "easy money" because it involves no debt.

Equity venture is a major process of investment in the financing scheme of the Islamic banking and finance. The main objectives of this scheme are:

1. To extend its facility to all types of industrial or commercial entrepreneurs according to the nature of their business.
2. To encourage technical assistance. Once funds have been advanced by the bank, it is upto the discretion of the borrowers to employ those funds as they wish, whether to make proper use of it or plunder for unproductive and uneconomical activities. There are some businessmen who borrow funds from banks to employ it profitably in some productive projects but, due to lack of personal skills, management control, poor administration and competitive entrepreneurship, they seldom succeed. The banks do not normally interfere with their business activities or guide them in funds management, with the result that such borrowers find themselves in serious financial trouble and cease to pay interest.

In equity joint venture an entrepreneur may pre-arrange finance from the Islamic financial bank, either for commencing a new establishment, or for expanding the existing business, or to foster technological development in a venture.[16]Equity financing is the only factor which is regarded as the heart and soul of Islamic finance but it too has both advantages and disadvantages while applying in the corporate sector. The advantages of equity financing are as follows:

1. You can use your cash and that of your investor's when you start up your business for all the start-up costs, instead of making large loan payment to banks or other

[14]Islami Tijara, "*Islamic Finance Ethical and Socially Responsible Financing",* Sep.2012 ,p.20.
[15] Umer Chapra,*Op.Cit.,* p.74.
[16] Mohammad Saeed Shingri, *A Model of Pure Interest-free Banking*, Qazi Pulishers, New Delhi,1994,pp.136-7.

organization or individuals. You can get underway without the burden of debt on your shoulder.

2. If you have prepared a prospectus for your investors and explained to them that their money is at risk in your new start up business, they will understand that if your business fails, they will not get their money back.
3. It depends on the nature of your investors; they may offer valuable assistance that you may not have. This can be important; especially in the early days of a new firm. You may want to consider angel investors or venture capital funding.

Disadvantages:

1. Remember that your investors will actually own a piece of your business; how large that piece is that depends on how much money they invest. You would not like to give up control on your business, so you have to be aware of while agreeing to take on investors. Investors do expect their shares in the profits, while if you obtain debt financing, banks or individuals only expect their loans repaid. If you do not make a profit during the first years of your business, you cannot expect payment from your investors, rather you have to pay back loan yourself.
2. Since your partner owns a piece of your business, you are expected to act according to their interest as well as your own. You need to check the Securities and Exchange Commission to see their requirements before you make decisions on how widely you want to open up your business for investment.

Mudarabah

Islamic modes of financing can be divided into two types; either they provide direct finance as capital funds through partnerships (*Mudarabha* and *Musharakah*) or they provide indirect finance through leasing (*ijarah*) etc. All modes are based on the principle of *riba* (interest) prohibition to maintain Islamic business ethics.

The word "*mudarabha*" has been derived from the Arabic phrase "*al-darb fil ard* " which means "to make journey". It is called so because the worker strives and wanders for business[17]. According to the terminology used by the medinan jurists, *mudarabha* is also called *muqarada* or *qirad.* According to al-kasani, they used to call *mudarabha* by the name *muqarada* just as they used to call *ijarah* as *ba'y*(sale). The term "*muqarada"* which is derived from the word "*qard*" meaning to refrain or abstain from something. The contract

[17]Dr. M. Tahir Mansuri , *Islamic Law of Contracts and Business Transactions,*Adam Publishers, 2007*,* p.275.

was called *muqarada* because the *rabb al-mal* refrained from the right of disposal in his capital and passed it to the *mudarib*[18]. This type of contract was found in pre-Islamic Arabia. Due to lack of water and scarcity of rains the inhabitants of Arabian Peninsula suffered from shortage of basic needs. To free themselves from this situation and to fulfill the basic needs, they lived in communities based on merchandise. For promoting merchandise many practices and contracts were carried on among the tribal Arabs, one among them was called *mudarabha* or *qirad*. In this practice a person having a good experience in trade but having no wealth of his own agreed to trade with a wealthy person on the terms agreed. This type of practice between capital and trading skill is called *mudarabha*[19]. One such example is narrated by Ibn Ishaq, he says in Makkah, Khadija bintkhuwaylid was a merchant woman of dignity and wealth. She used to hire men to carry merchandise outside the country on a profit sharing basis (*Al Mudrabah*). According to him when Khadija heard about Prophets's truthfulness and trustworthiness, she sent for him and proposed that he should take her goods to Syria. The prophet prior to his prophet hood acted as an agent in a *Mudarabah*contract, with an investment provided by Khadija.[20]The practice of Mudaraba was continued by the companions. Hazrat Umar made a contract of*mudaraba* with his sons Abdullah and Ubaidullah by taking the principal and a half of the profit and giving them the other half of the profit. Hazrat Uthman used to provide some money to his agent in a Qirad transaction and shared the profit between them.[21]

Mudarabah is considered generally as a contract of partnership where both the partners share profit and loss equitably, but that is not the case. It is the(capital) *Rabb-al-Mal* who is subject to pay the entire loss and the agent(Mudarib) who is to carry out the business, losses only his labour. *Mudarabah* is a different contract which involves only two persons; the financier (who invests the capital) and the agent (who uses his skill)[22]. The agent works with it and returns the principal amount along with profit to the investor as a reward for his labor grants him the remaining share of the profits[23].According to Ali al-Khafif, "It is the contract for sharing the profit of a business in which one party contributes with capital and

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[18] Imran Ahsan Khan Niyazi, *Islamic Law of Business Organization Partnerships*, Kitab Bhawan, Delhi, 1999, pp.243-44.
[19] Syed M. Ismail, *Critical Analysis of Capitalism, Socialism and Islamic Economic Order*, Oriental Publications, Delhi, 1992, pp.465-66.
[20] Abdullah alwi Haji Hassan , *Sales and Contracts In Early Islamic commercial Law,*Kitab Bhawan, New Delhi, 1997, p.88.
[21]*Ibid*, p.90.
[22] Dr. M. Muslehudin, *Banking and Islamic Law,*Adam Publishers, New Delhi, 2007, p.67.
[23] Abdullah Alwi Haji Hassan, *Op.Cit.*,p.87.

other with his labour".According to Dr. Rashad Khalil, "It is a contract whereby a legally competent person hands over a known and defined capital to a person possessed with reason and discretion to trade withit for a part of profit defined in proportion[24]".

Conditions

The conditions of *Mudarabah* contract are as: - the capital should have the legal capacity to become a principal in a contract and the *Mudarib*should have the capacity to be an agent. It is necessary for the Mudarib to understand the terms and conditions of the contract. All such capital, with which other partnerships are valid, is acceptable for this partnership contract. The capital must be delivered to the *Mudarib* to commence the work. The amount of the capital should be known to the parties at the time of contract[25]. The profit should be distributed within the partners at a pre-determined ratio. Hadrat Ali was of the opinion that the proportional division of the profit should be arranged in accordance with what has been agreed by the two partners in the contract[26].Money should be in currencies and in tangible property or debts[27]. Ibrahim al-Nakhai disapproved dry goods such as cloth and Linen to be used as capital in *al-Mudarabah. Hammed Ibn Abe Suleiman, Hassan al-Basri and Mohammad Ibn Sirin* agree that the capital should be gold and silver[28].

3. Types of Mudarabah

Generally there are two types of *Mudarabah*: 1. The Restricted *Mudarabah*2.The Unrestricted *Mudarabah.*

1. The Restricted *Mudarabah*:- is a type of *Mudarabah* in which *Mudarib* has to perform his actions within certain limits and restrictions[29].It may be in terms of kind, time and place.[30]
2. Unrestricted *Mudarabah:-* when a *Mudarabah* contract is free from all restrictions regarding time, place, trade policy and person with whom business is to be done is called unrestricted *Mudarabah.* The partner is allowed to use the money in the field which he feels fit. His authority in investing the capital may extend for earning profit.[31]

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[24] Dr. M. Tahir Mansuri, *Op. Cit*.,p. 276.
[25]Imran Ahsan Khan Niyazee, *Op.Cit*., pp.258-59.
[26] Abdullah Alwi Haji Hassan, *Op.Cit*., p.90.
[27] Imran Ahsan Khan Niyazee, *Op.Cit.,* p. 259
[28] Abdullah Alwi Haji Hassan, *Op.Cit.,* p.91.
[29] Imran Ahsan Khan Niyazee, *Op. Cit*., p.256.
[30] Dr. M. Tahir Mansuri, *Op.Cit*., p.284.
[31] Dr. M. Tahir Mansuri, *Ibid.,* p.283.

Musharakah

The root word of *musharakah* is "*sharika*" which means sharing, mixing or partnership. According to Syed Mohammad Ismail, it means association of persons to conduct their economic exploits in the form of partnership in the early Muslim society.[32]Legally it means that if a property belongs to several owners and each one has ownership of every smallest part of it in proportion to the share allotted to him[33].It means when partners participated they bring about the mingling of wealth and wealth is held jointly by them[34]. The partnership comes into existence through a contract or through the mixing of wealth[35]. According to Hanafi school of thought, it is a contract between two or more people for participating in capital and its profit[36]. Under this contract the partners merged their capital and jointly strive to earn wealth through economic activities which were confined to trade and commerce. AllamaAbdur Rahman al-Jazeeri in his work, "*Kitab ul fiqhalalMazahib ul-Arbah*" says that, "in *Musharakah* the contributed share capital of every partner is mixed up in a pool, so that there should be no discrimination with the share capital of another partner. The use of word *"shirkat*" conveys different meanings because of many varieties of *shirkat*[37].*Al sharika* business transactions were widely practiced in the pre-Islamic period. The Arabs used to write down their agreement of partnership in business transactions in the form of written documents to avoid any disagreement. Such partnership was normally undertaken by traders of Mecca-Yeman and al-Sham. From this historical evidence, it may be said that there is a difference between *Mudarabah* and *Musharakah*. In *al-Sharikah*, the capital can be provided by one or more partners whether in cash or immovable property. All profits are divided among the share holders in accordance with their agreement or losses are shouldered by them. Study of various reports show that these partnerships were practiced in the pre-Islamic period. It was reported that Nawfal ibn-al Harith ibn abd al-Mutalib became the partner of al Abbas ibn abd al Mutalib in mercantile partnership. Sayfi ibn Aidh became a partner of the Prophet, before his prophethood in trade in the Yemen. Al Saaib ibn al-Harith Sabirah was also a partner of the Profit in the pre-Islamic times in Mecca. It was reported that the merchants of Yemen and Hira used to be engaged in such a partnership in pre-Islamic era. According to some reports al Abbas ibn Mirdas al Sulami was the partner of Harb ibn

[32]Syed Mohammad Ismail, *Op. Cit.,*p.442.
[33] Abdullah Alwi Haji Hassan, *Op.Cit.,*p.104.
[34] Imran Ahsen Khan Niyazee,*Op.Cit*, p.14.
[35]*Ibid*. p.15.
[36] Dr. M. Tahir Mansuri, *Op.Cit.,* p.240.
[37] Syed M. Ismail, *Op.Cit*., p.442.

Ummaiyah and al-abbas ibn Anas was a partner of Abd Allah ibn al-Mutalib(the father of Prophet SAW in pre-Islamic times.[38]

Types of Musharakah

There are two types of Musharakah:

1. *Sharikat al-Milk* (Proprietary partnership).
2. *Sharikat al- 'Aqd* (Contractual partnership).

1. **Sharikat al-Milk**: is defined as the existence of a thing in the exclusive joint-ownership of two or more persons due to any reason of ownership, or it is the joint claim of two or more persons for a debt that is due from another individual arising from a single cause.

   In this type of partnership each and everyone has ownership in every smallest part of the capital. The property, which is difficult to divide and distinguish, forms the subject matter of this partnership.[39]

2. **Sharikat al-'Aqd**: comes into being as a result of agreement between two or more persons in order to share the profits.

Conclusion

The economic system modeled on capitalist principles has been observed to have achieved a great deal of economic prosperity. However, this growth has come at a huge cost both from environmental and human development perspective. Islamic financial system has been widely embraced by western economies in general and Muslim countries in particular. The financial system espoused by Shariah compliant principles popularly known as Islamic financial system or participatory banking system attracted global attention due to its near cent per cent immunity during the financial crisis of 2008. To address the economic infirmities Shariah based equity models would come along way in overcoming these problems and sustaining a more stable and equity driven economic system. These equity models incorporate principles which thrive an egalitarian economic and financial system as the capital invested and returns from these investments is shared equitably among all stakeholders. But these models should be carried out under more supervision and management.

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[38]Abdullah Alwi Haji Hassan, *Op.Cit.,*p. 104.
[39] Dr. Mohammad Tahir Mansuri, *Op. Cit.*, p. 244.