

Islamic Banking: Why Not *Mushārah* Financing?

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Abstract

Risk-sharing is deemed as the hallmark of Islamic banking. But partnership-based financing did not gain general acceptance among Islamic banks. This paper takes note of the adaptation of *mushārah* as mode for financing. It then explains an alternative adaptation that might allay some of the apprehensions about *mushārah* financing. It also draws attention to the type of effort that Islamic banks will need in order to popularize *mushārah*-based financing.

Keywords: *Mushārah*, Financing, Islamic banking, Running *mushārah*

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1. Introduction

Islamic banking started with risk-sharing deemed as its ethos. Some initial ideas in this direction came from Uzair (1955), al-Sadr (1962), Siddiqi (1983) and CII (1980). Islamic banks happily accept deposits on profit-and-loss sharing basis. The situation is not quite the same in financing and investment matters. In the initial phase of Islamic banking, partnership-based financing was on the cards. But things scarcely moved beyond academic discussions. In the Islamic banking literature, emphasis gradually shifted from *muḍārah* financing (Islamic bank only providing funds to the client) to *mushārah* financing (with both the bank and the client pooling their funds). *Shirkah al-milk* based diminishing *mushārah* financing has been a significant development on both theoretical and practical planes. But its popularity can be attributed to its close resemblance between the current adaptation of diminishing *mushārah* financing and mortgage financing and financing on the basis of *ijārah muntahiyah bi al-tamlīk* (lease ending with ownership by the client) both of which are debt-financing modes.

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There are examples of successful adoption of *mushārah*-based financing in Sudan (Khaleefa, 1993). However, in general *mushārah* financing is gradually going into the background. This is evident from, among other things, space devoted to explanation of *mushārah* financing and number of its practical examples in the textbook published by ISRA (2011), the official arm of Bank Negara Malaysia for promoting research and teaching in Islamic finance. Various reasons can be given for non-popularity of *mushārah*-based financing; for example, moral fabric of society, availability of less-risky modes of financing and the current taxation and legal system. This research adopts a different line. It follows the following research question: Can indifference to *mushārah* financing be due to lack of its proper adaptation? The issue is explored both at conceptual and practical levels. The argument begins, in section 2, with a brief review of how *mushārah* is understood and implemented for Islamic banking. Section 3 offers a fresh perspective on *mushārah* and its Shari‘ah requirements. Section 4 looks into some practical matters. Section 5 concludes the discussion while also pointing out some steps for making *mushārah* financing an integral part of Islamic banking.

2. Review of *Mushārah* and Existing *Mushārah* Financing

The term “*mushārah*” is relatively recent. In classical *fiqh*, Islamic jurists talk about *shirkah*, sometimes spelt as *sharikah*, i.e. a partnership. The primary classes of *shirkah* are *shirkah al-milk* (partnership in property) and *shirkah al-‘aqd* (contractual partnership). The latter is subdivided into *shirkah al-mufāwadah* (partnership with all partners being equal in their shares of capital, role functions, profit-sharing ratios, etc.) and *shirkah al- ‘inān* (contractual partnership with the partners being unequal in some or all of the said respects). *Shirkah al-‘inān*, in turn, is further divided into *Shirkah al-‘amal* (contractual partnership in effort), *Shirkah al-wujūh* (contractual partnership on the basis of goodwill) and *Shirkah al-amwāl* (contractual partnership in capital). *Mushārah* is basically *Shirkah al-amwāl* in the *Shirkah al-‘aqd* class.^{1,2}

Fiqhī discourse on *mushārah* mostly starts by viewing *mushārah* as “contractual partnership in which all partners provide funds, not

¹ See, for example, Usmani (2002, p.5).

² In the *fiqh*, *muḍārah* is regarded as a class of its own. AAOIFI has issued its accounting and Shari‘ah standards separately for *mushārah* and *muḍārah*. This is a debatable matter. Why can one not be seen as a special case of the other: *muḍārah* as a limiting case of *mushārah* or *mushārah* as reciprocal *muḍārah* between two parties. This paper stays away from such points and focuses only on *mushārah*.

necessarily equally, and have the right to work for the joint venture³”. Legal capacity of the contracting parties and formal offer and acceptance are deemed as understood conditions. The focus is on conditions for:

- 1) the capital of the *mushārahah*,
- 2) managing of *mushārahah* venture,
- 3) sharing of profits and losses,
- 4) guarantees, and
- 5) termination of a *mushārahah* project or business.

As for the capital, the thrust of the argument is that capital be defined in monetary terms. If a partner comes into the picture with physical assets, his contribution would be mutually agreed monetary equivalent of the things at hand. This is understandable because it is helpful at the final settlement time. AAOIFI’s accounting standard is also explicit on how the Islamic bank’s capital is to be treated at the bank’s level.⁴

There is general agreement on sharing of profits in terms of ratios that are mutually agreed at the time of agreement or starting any business or project. Incidence of loss is to be borne by capital and, hence, by the partners in proportion to their equity stakes. The concept of sharing profits before termination of *mushārahah* is permissible; however, all such distributions are deemed provisional until the time of final settlement of the *mushārahah* transaction.

As for termination of a *mushārahah*, possibilities of premature truncation of a transaction are recognized.⁵ The death of one of the partners is one such factor. Exhaustion of the *mushārahah* capital due to losses, is another. In general, one or more partners may seek termination of *mushārahah* because it is viewed as a trust arrangement between the partners. However, conditions in the agreement are allowed to ward against adverse implications of such a thing for all partners.

True perception of *mushārahah* comes to fore in the discussion of rules for working of *mushārahah*. The Sharī‘ah Standard of AAOIFI (2010 b, pp. 205-206) lists them under Managing a *Shirkah* venture”, and Ayub (2007, pp. 314-315) explains them under Mutual Relationship among Partners and *Mushārahah* Management Rules. The most important point is that each partner is deemed as *wakīl* (agent) and not as *kafīl* (indemnifier) of the other partner(s). In Usmani’s words, “if all the partners agree to work for the joint venture, each one of them shall be

³ See Ayub, 2007, p.308.

⁴ See AAOIFI (2010a), Clause 2.

⁵ See Ayub (2007), p. 318-9 for the details.

treated as the agent of the others in all the matters of the business and any work done by one of them in the normal course of business shall be deemed to be authorized by all the partners”.⁶ In general, “the normal course of business” covers a wide variety of things the details of which are provided in the references noted here. Of course, some safeguards may be built into the transaction by the concerned partners by bringing in some restrictions on the working partners, bank’s clients in financing matters. But the main point to be noted is that the working partner is permitted to do transactions in his own name while those transactions have economic implications for the others as well.

The adoption of *mushārahah* financing for Islamic banks has been along the above lines. Reference may be made to such a model instrument approved by the Shari‘ah Board of the State Bank of Pakistan in April, 2005. Its softcopy is available on the internet.⁷ The following features are noteworthy:

- 1) The instrument evidences a bank giving financing to a client on profit-sharing basis with the understanding that the latter would combine it with his capital, do the business in his own name and share the ensuing profits with the bank, of course, at mutually agreed profit-sharing ratio.⁸
- 2) Safeguards are also built into the transaction in order to ensure that profit accruing to the bank is reasonable failing which the bank may take some remedial action.

The second point is a slight departure from the notion of fixity of profit share. Its basis is that a partner can voluntarily concede a part of his share in favour of the other partner.

3. *Mushārahah* and its General Shari‘ah Requirements – A Restatement

Mushārahah is a sharing arrangement. But what does “sharing” mean? Take the case of two individuals X and Y who buy apples from wholesale market and sell them in retail market. Suppose X and Y, respectively, start with Rs.500 and R.750. Their business streams run as follows:

Rs.500 of X \Rightarrow the apples purchased \in X \Rightarrow Sale Proceeds, say,
Rs. 600 \in X \Rightarrow Rs.500 return to X + Rs.100 \in X

⁶ See Usmani (2002), p. 10).

⁷ <http://www.sbp.org.pk/press/essentials/Musharaka%20Investment.htm> (downloaded on 17 January 2014).

⁸ The financial instruments in Malaysia too confirm this impression. See, for example, BNM (2010) and ISRA (2011).

Rs.750 of Y \Rightarrow the apples purchased \in Y \Rightarrow Sale Proceeds, say,
Rs. 900 \in Y \Rightarrow Rs.700 return to Y + Rs.150 \in Y

In the end: X gets back its original Rs.500 and the profit of Rs.100 goes to him, and Y gets back its Rs.750 and the profit of Rs.150 belongs to him.

Now let us consider both X and Y sharing their capital, and keep the rest of numbers the same. What would happen in this case? The answer is:

Rs.1250 \in both X & Y \Rightarrow the apples purchased \in both X & Y \Rightarrow
Sale Proceeds of Rs.1500 \in both X & Y

At the settlement time, the composition of Rs.1500 would be as follows: Rs.1250 would stand for capital of the joint venture, Rs.500 coming from X and Rs.750 from Y, and would go back to their respective contributors. The surplus of Rs.250 (= Rs.1500 – Rs.1250) would belong to both X and Y. If the agreed profit-sharing ratio were linked to the equity stake of each partner, this said joint surplus will be shared with X and Y getting Rs.100 and Rs.150, respectively. It should now be easy to see that once partnership is established, individual identities of the partners are replaced by a joint entity and any appreciation or depreciation / addition or depletion of capital due to profit or loss, respectively, belongs to both that is named “both X & Y” in the above illustration.

As for working by the partners, there cannot be hard and fast rules. In the above example, X and Y may agree to put in, for example, equal effort, but their respective effort may not have equal yield. For instance, X may act as seller from 9am to 1pm without any results, and all sale proceeds may come from Y selling from 1pm to 5pm. Nature and importance of each partner’s effort may be acknowledged through variation in profit-sharing ratio. Two things are worth pointing out here.

Firstly, when a *mushārahah* contract is enacted, a legal person comes into existence, referred to as “both X & Y” in the above illustration. Thus, when one of the partners acts, he does so for and on behalf of the said legal person, not as agent of the other partner. The existing thinking in this regard, as noted above, needs reconsideration. It has important implications for design of *mushārahah* contract.

Secondly, *mushārahah* is a voluntary contract. There is nothing hard and fast about different partners’ roles articulated by the learned *fuqahā’* from time to time. Every *mushārahah* contract may be linked to a well-defined purpose. It may be time-bound for meeting banking needs. The contract may be designed such that periodic distribution of profits takes

place with each such distribution being final, not provisional. There also needs to be clarity on the expenses that may be treated as costs of *mushārah* operations. Last but not least, there ought to be explicit agreement on settlement procedures and, if necessary, provisions for arbitration.

A suggested list of rules for designing *mushārah* financing contracts is given hereunder:⁹

1. **Offer and acceptance.** This is to confirm free willing consent of all partners to the *mushārah* and its terms and conditions.
2. **Specification of the purpose and scope of the partnership,** i.e. the extent to which each partner will share its resources with the other. This also helps to protect financing partners from losses stemming from unwanted application of the partnership resources.
3. **Duration of the partnership and the time of final settlement.** All partners must know when *mushārah* would truncate. If the agreement is silent on this vital matter, legal complications may stand in the way of orderly closure of a *mushārah* transaction. Therefore, the closure matters cannot be left to be sorted out as and when the need arises.

In general, the partnership may be for a single transaction. For example, export against a confirmed order. In this instance the duration of financing would begin with the signing of the contract, and end with the realization of export proceeds and settlement with the client. Alternatively, the financing may be for a period over which business activity might take place, such as a few weeks, some months, a year or several years. If the transaction period is longer, issues related to periodic distribution of profits would also require attention.

4. **Equity stake of each partner and total capital of the joint venture.** In general, the capital of *mushārah* must be defined in monetary terms. This is in line with how settlement normally takes place in the end—i.e. in cash terms. Thus, if equity of a partner is in material form, its cash equivalent will be the said partner's equity contribution. In the case of non-durable goods, mutually agreed fair market value will be relevant. In the case of durable goods, however, two options exist:
 - (i) The durable goods, such as plant and equipment, may itself be recorded as the respective partner's capital. And, at the settlement time, on the analogy of returning monetary capital in nominal

⁹ This is an improved list of conditions listed in IIIIE (1999).

terms, the said good may be returned after restoring it to its original state by taking care of any wear and tear. Expenses in this regard shall constitute a charge on the *mushārahah* funds while determining distributable surplus.

An obvious disadvantage of this approach is that final settlement will be delayed until depreciation matters finish. Here the second option comes into the picture.

- (ii) The capital in lieu of the item may be defined in terms of the rental for that item for the period of the joint venture. The rental itself may equal to the expected depreciation cost. Later on, after the start of the partnership, the respective item may be acquired on lease by the joint venture for the said rental. While no money may actually change hands at the time of the joint venture's inception and at the time of leasing the said thing, at the time of final settlement nominal equivalent of the rental shall be payable to the good's owner in lieu of his initial contribution (made on paper only).

This second approach has as obvious advantage. If machinery were taken on lease by the joint partnership, it would be absolved of the responsibility for depreciation matters: responsibility for wear and tear and maintenance of the asset in working condition falls on owner/lessor. This should expedite the final settlement process.

5. **The creation of a joint venture.** As explained above, when a partnership is created, personal identities of the partners go into the background, and a joint entity comes into existence. The business operations—holding assets, responsibility for liabilities and transactions with suppliers and customers—take place at the joint level. Accounts and books of the venture are maintained at the said joint level. And, last but not least, litigation, whether for or against, is also in the name of the joint venture. The partnership agreement needs to take cognizance of all these points. That is to be achieved by creating a legal person standing for the joint venture in lieu of the *mushārahah* contract between all the partners.

At the practical level, two things need to be done. First, there should be agreement between the partners on the name—different from their personal names—under which the partnership is going to work. Second, the partnership will need to be registered under the relevant laws in order to signal to the society at large and the relevant authorities the extent to which personal identities of the respective individuals would be replaced by the joint venture.

Careful Attention needs to be paid to the following aspect of *mushārah* financing. Once a *mushārah* has been created, the transactions by either partner will be for and on behalf of the *mushārah* entity, not the other partner.

6. **Formula for the distribution of profits.** The profit-sharing formula ought to be fixed in advance so that each partner knows the exact fraction or percentage of the profits that he would be entitled to when profit-distribution takes place. It may be either a single profit-sharing ratio or some formula leading to a precise profit-sharing ratio.
7. **Principle for sharing of losses, if any.** There is no disagreement on the general principle that material losses are to be shared by all the partners in proportion to their equity stakes with effort of the working partners going unrewarded. Its explicit incorporation in *mushārah* contract would alert the working partners about their interests.

During the tenor of *mushārah* the working partners are supposed to meet their personal needs through (1) their personal means or (2) borrowing from a third-party. They can, of course, make up for the said expenses or borrowings through their share in the profits that is, of course, negotiable. Notwithstanding this, the following alternative arrangement is also possible within the framework of the *mushārah*. The working partner(s) may be advanced loans for his (their) personal expenses from the partnership's funds. Such loans will be receivables for the *mushārah*. The said loans can be adjusted against the claims of the respective partner(s) at the settlement time. In case, *mushārah* runs into loss, liability to the extent of the borrowed money would fall upon the working partner(s).

The foregoing explanations imply that if the *mushārah* either earns no profits or runs into losses, the effort of working partners would be worse off (to the extent of the personal expenses incurred by them during the tenor of the partnership). Accordingly, they would have every reason to work hard for bringing about positive results. In other words, the possibility of loss-sharing by the provider of capital may go into the background. Thus, the *mushārah* may work as a profit-sharing—not a profit-and-loss-sharing—arrangement, although the possibility of loss due to external factors cannot be ruled out.

8. **Role/ functions of the partners.** With mutual consent every partner can perform a role that best suits collective interests of the joint venture and, at the same time, his personal interest. For example, in the case of *mushārah* financing, the bank may look after accounts of the

joint venture, and with appropriate checks and balances practical matters may be left to the client.

9. Modalities for running of the business. The *fiqhī* discourse on *mushārah* does not highlight this point. However, it holds the key for success of *mushārah* financing. The following suggested formalities are self-explanatory;

- a) An account in the name of the joint venture may be opened with and operated by the bank.
- b) All payments may be made from the joint account maintained by the bank, and all cash inflows may be deposited in it at the end of the same business day.
- c) The working partner may be given some cash limit for incidental expenses.
- d) All purchases above a prescribed minimum—say \$20,000—may require prior permission of the bank.

The above arrangement is similar to practice followed by banks for corporate financing.

10. The extent to which indebtedness may be created against the name of *mushārah* venture and the limit to which credit may be created on its name. Such restrictions are useful for, among other things, timely settlement of *mushārah* contracts.

11. Zakāh matters: *Zakāh* is payable on *māl* (wealth) and assessable against and payable by whoever is at the ownership end when *zakāh* becomes due according to the Sharī‘ah principles for *zakāh*. Negotiating *mushārah* financing contracts with non-Muslim fund-seekers shall be a tricky matter. A choice would have to be made by Islamic financiers between economic gains and pleasing Allah SWT.

12. Accounting matters: Everything that matters for the final settlement needs to be clear at the outset. Some examples in this regard are:

- a) Recognition as cost (to the joint venture) of only those expenses that are payable to third parties for the working of the partnership;
- b) Broad description of personal expenses of working partners that may not be charged to the partnership account;
- c) Apportionment of the utilities and similar other charges if the *mushārah* is to draw upon some partner’s resources outside the ambit of the joint venture; and

- d) Valuation of fixed assets and unsold merchandize during the tenor of the partnership (*see also below*).

13. Principle for settlement of accounts: Some relevant points in this regard are as follows:

- a) Whether there would be a one final settlement. Or would there be periodic distribution of profits as well?
- b) The period during which final settlement is to be made should be known. For example, within one week after the end of the partnership.
- c) Capital of the respective partners ought to have the first charge on the funds in the name of the joint venture at the time of settlement, whether periodic or final.
- d) Treatment of the receivables in the joint venture's name
- e) Principles for disposal of any fixed assets and unsold merchandize

The last two points are likely to be contentious matters in *mushārah* financing. In the case of fixed assets and unsold merchandize, settlement may take effect after disposing them of in the open market. But that may take time. In order to avoid that the respective partners may bid among themselves, and the amount so determined may be adjusted against their share in the profits.

14. Pledges (collateral) and guarantees to protect financing partners' interests and procedure(s) for resolution of any disputes: If everything works out according to plan and the *mushārah* earns profits, there is no need for these things. However, covers for financing might be needed in order to forestall losses stemming from any wilful violation of the terms of the *mushārah* by a partner. In such an event, the least that the financing partner might like is to get its funds back without delay. Collateral and guarantees may be helpful in this regard. Of course, procedures and other formalities for arbitration and conflict resolution also need to be spelled out in the partnership agreement.

15. Legal cover. This would be needed in order to enact a *mushārah* through registration of the partnership under the Partnership Act of the respective jurisdiction. Collateral deeds and personal guarantees also need to be registered with the relevant authorities.

Registration of the partnership in its agreed name will provide legal cover for all the partners as well as the transactions carried out in the name of the joint entity. Furthermore, advance registration of

pledges and guarantees with the judicial authorities, will expedite the necessary action if such a need arises.

The above is a comprehensive list of conditions for a *mushārahah* transaction. If *mushārahah* agreements take care of all the matters indicated above, the risk factor is expected to be normalized to purely market risk. With good research and planning and choice of investment proposals, that risk too can be minimized. The profit-sharing formula may also be set such that the client maximizes its gains while, at the same time, the bank gets suitable profits. This can be done, for example, by setting the formula for distribution of profits such that the share of the client grows with increasing profits, and after a certain level of distributable profits from the bank's point of view has been achieved, even all additional profits may go to the client (provided it does not become a norm). In passing, one may add that there is always room for safeguarding interests of financial institutions through collaterals and third-party guarantees. But role of such measures is to be limited to ensure smooth running of *mushārahah* financing operations by Islamic banks.

An observation may be made about acceptability of the above conditions to parties seeking financing. To the extent that *mushārahah* does not mean a permanent ownership stake for the financier and represents a profitable proposition, there should not be much problem.

4. Some Practical Considerations in *Mushārahah* Financing

Existence of value-added activity at the client's end is a prerequisite for *mushārahah* financing. Industry, agriculture and foreign trade are three important areas that meet this condition. Each of these areas, however, offers some unique challenges. For example:

- a) In the industry's case, the client already has plant and equipment—capital in a physical form and some other means to cover overhead costs such as salaries of permanent staff. He needs working capital.
- b) In the case of agriculture, a client's needs may not require sizeable financing but the number of potential beneficiaries of *mushārahah* financing may be quite large.
- c) In the case of foreign trade, details of *mushārahah* financing for exports are likely to differ from those for imports.

Attention to the measures in the above cases is drawn hereunder in somewhat broad terms.

4.1 *Mushārah* Financing for Working Capital Needs of Industry

As for the industry, *mushārah* with the respective firm may be cast in monetary terms while leaving aside the latter's plant and equipment. The plant and equipment may then be hired by the joint venture created in lieu of the *mushārah*. In a more refined version of the *mushārah* contract, expected depreciation costs can be regarded as the client's monetary contribution, and then the plant and equipment may be hired by the joint venture at the rate equal to this depreciation cost.

It is pertinent to make a few observations about RM, a novel financing product proposed by Usmani (2002, pp. 23-26) and recently popularized by Islamic banks in Pakistan for satisfying working capital needs of industry. It is a bold attempt to mimic overdraft financing facility or running finance in interest-based banking. The idea behind RM is to let "clients draw different amounts at different intervals, but at the same time, they keep 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" (Usmani, 2002, pp.23-23).¹⁰

In order to appraise the Sharī'ah credentials of RM, a reminder of the following points is necessary. When a *mushārah* is created, say, for one year, a joint account stands opened with the bank in the name of the partnership. While the account is maintained by the bank, both the client and the bank may have role in its operation. There is a string of debits and credits to this joint account until the end of the duration of *mushārah*, a year in the example at hand. The *mushārah* capital may be recycled many times over. Only at the end of the year the issue of separation of equity stakes of both partners (for repatriation of their capital) arises. Profits, if any, are distributed at pre-agreed rations. RM violates the Sharī'ah rules on, at least, the following scores.

The bank opens a Running *Mushārah* account in favor of the customer with a financing limit, i.e. the maximum amount the client may draw but need not do so. The amount actually drawn by the customer is deemed the bank's investment in the customer's business. It is noteworthy that this is treated as the customer's account with the bank, not the joint account of the customer and the bank, managed by the bank, as it should be under the notion of *mushārah*.

¹⁰ A substantial illustration of Running *Mushārah* is available at:

<http://icib.riphah.edu.pk/sites/default/files/files/Ahmad%20Ali%20Siddiqui-Running%20Musharakah.pdf>

Equity stakes of the bank and the client are also not fixed. Setting the equity contribution of a partner and actual utilization of the funds committed by it are two separate acts. Therefore, the bank may commit a large sum, i.e. a high financing limit, but at any given time hand over only part of it for use to the client. In other words, the remainder may remain in the bank's possession till such time as it is needed by the co-partner. However, accounts of the *mushārahah* shall reflect the entire sum committed by every partner. The equity stakes of the various partners remain the same till such time as the *mushārahah* contract ends. Only in the case of diminishing *mushārahah*, variation in the equity stakes of the various partners is allowed under set rules for that purpose. In the case of Running *Mushārahah*, the daily product method introduces artificial valuation of capital by linking it to the client's ability to replenish the account of the financing facility. Besides questionable treatment of capital of the *mushārahah*, in Running *Mushārahah* the actual profit-sharing ratio is determined *ex post facto*. This is a serious violation of the Sharī'ah conditions for partnership contracts. This is like having an employment contract without setting the wage. While such a thing may happen in isolated individual cases, their organized practice at institutional level has no place in the Sharī'ah milieu.

Last but not the least, some issues remain about the contract governing a Running *mushārahah*. In principle, a *mushārahah* contract is to be linked to specific business and economic targets of the concerned fund-seekers. The same is also expected for Running *Mushārahah*. If the architecture of a Running *Mushārahah* limits financing to selected transactions by the client and absolves the bank of its natural obligations as a partner, it can hardly be called a partnership. Some action is necessary to dispel the impression that Running *Mushārahah*, as it is practiced, is a *Tawarruq* type arrangement in which banks earn on their liquidity without regard to the profitability or the use of funds by the client.

4.2 *Mushārahah* Financing for Agriculture

A bank can provide *mushārahah* financing to farmers at a large scale through a special subsidiary created for this purpose. The said subsidiary may be assigned financial resources and agricultural inputs. A standard partnership agreement may be designed which can be tailored to the needs of different farmers for agricultural inputs. Precedence to this effect has been set by Sudanese Islamic Bank in the early 1990s.¹¹

¹¹ See the article by Khaleefa (1993) for some interesting details.

4.3 *Mushārahah* Financing for Exports and Imports

Working capital needs of exporters and importers can be met through *mushārahah* financing, of course with some changes in the above procedure proposed for financing trade and commerce. But exports and imports take place according to internationally set rules with L/C, bill of lading, bill of exchange and some other instruments. Banks are always a part of the transaction process in foreign trade.

Exports and imports generally take place against confirmed sales contracts between exporters and importers. The said contracts also make an allowance for role functions of exporter's and importer's banks in lieu of transfer of ownership of the merchandize and payment matters. If *mushārahah* financing is involved, joint venture between the bank and exporter/importer will also come into the picture. This is because in principle *mushārahah*-based transactions are supposed to be for and on behalf of the joint venture created in lieu of the *mushārahah*. This, in turn, implies some procedural changes as well as allowance for pricing of banking services in foreign trade. Procedurally speaking, exports and associated claims would be in the name of the joint venture. Likewise, imports and associated obligations would be discharged at the level of the joint venture.

The profit margin on financing exports is easy to work out: the export price is generally given and domestic costs can be determined with fair degree of accuracy. So *mushārahah* financing may be a fail-safe operation for the respective bank. However, L/C and other formalities are to be completed in favour of the joint venture. Sale contracts between the exporter and the foreign importer may have a provision to this effect. If the partner bank also takes up the responsibility for collection of payment from the foreign importer, it is expected to do the needful on cost basis, not market rates: in principle, only expenses payable to third parties are to be treated as costs to a *mushārahah*. Of course, the exporter-cum-partner would be responsible for preparing and shipping the merchandize.

On the import side, the partner bank may look after the paper work and complete other formalities assigned to financial institutions under the standard rules for foreign trade. However, letter of credit will need to be opened in the name of the joint venture and the consignment to be received by the importer-cum partner for and on behalf of the joint venture. The said steps are necessary because the joint venture becomes a legal person in the transaction process. Again, if the same bank guarantees the letter of credit, no fee might be charged. And, other banking services

to the joint venture may be provided by the partner bank on cost basis, not on market rates.¹²

4.4 *Mushārahah* Financing – Some Challenges Ahead

A lot of further research is needed in order to remove any apprehensions about *mushārahah* financing. Institutional setup, investment appraisal staff, standard operating procedures, relatively simple financial instruments are some of the points that come to attention. However, urgent attention needs to be given to legal and tax matters and creation of short-term partnerships. Both legal as also tax issues would have to be resolved for making *mushārahah* a preferred mode of financing for Islamic banks.

The partnership and the banking Acts of different countries need changes to remove hurdles in the way of *mushārahah* financing. The legal procedures have to be simplified and their costs, if any, brought down.

5. Concluding Observations

Mushārahah financing is relevant in all cases that involve value-added activity leading to generation of output and profits. It is primarily a profit-sharing mode of financing. Loss-sharing is only technical implication of the concept of *mushārahah*. *Mushārahah* financing can always be designed such that chances of loss are negligible. Prospects of loss can also be avoided by suitable choice of area of financing and design of the instrument closing loopholes for foul play by fund-seekers and, last but not least, through adequate covers for financing.

Reservations against *mushārahah* financing are due to some misconceptions and this paper is an attempt to draw attention to some of them. Serious, in-depth research is needed to clarify fine points. For example, how Islamic banks may enter into *mushārahah* financing with on-going businesses; how book-keeping and accounting may be carried out at the clients' end for funds provided under *mushārahah* financing; and what should be the parameters and procedures for evaluating *mushārahah* financing requests. Notwithstanding all these, however, *mushārahah* financing may prove to be an efficient tool—as compared to *murābaḥah*, *ijārah* and other debt-based modes of financing—in all cases where chances of profit-making exist at the fund-seekers end.

¹² See Tahir (1994) for further details on *mushārahah* financing for exports and imports.

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