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A STUDY OF EQUITY FINANCING MODES FOR ISLAMIC FINANCIAL INSTITUTIONS IN A SHARI'AH PERSPECTIVE

BY

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ABSTRACT

This thesis analyses major areas related to implementation of the Islamic equity financing modes of *mushārakah* and *muḍārabah* by Islamic financial institutions from a Shari'ah perspective, with a view to highlighting important principles and aspects requiring review. It attempts to suggest possible measures for upgrading current practice in order to strengthen the shari'ah basis and realise the socioeconomic objectives of these modes. The research consists of a brief survey of the concept and regulations of *shirkah* and *muḍārabah*, and a detailed analysis of selected aspects related to four major areas of equity financing by Islamic banks, viz. capital, profit and loss sharing, equity investment accounts and project financing.

Under capital in equity financing, the existence of capital at commencement, conversion of debt into capital, and involvement of commodities as capital are analysed. The Shari'ah theory pertaining to the nature of capital is examined in detail. The research shows that the current method for determining the profit sharing ratio in equity ventures based on the application of the rate of return on capital and the period of exposure needs revision. Two alternatives are proposed based on the capital and labour contributions of the partners. Stipulations affecting the functioning of the profit sharing ratio are scrutinised. The effect of withdrawal and period of investment on allocation of profit among investors in equity investment accounts is examined. The study highlights the need for a system for allocation of loss among investors. An alternative scheme for investment accounts is outlined. Important aspects of decreasing partnership and other equity structures for project financing are analysed. It is shown that adopting the equity basis could curb some negative aspects found in debt financing structures.

ملخص البحث

تبحث هذه الرسالة مجالات رئيسة تتعلق بطرق التمويل الإسلامية: المشاركة والمضاربة، من حيث تنفيذها بالمؤسسات المالية الإسلامية من منظور شرعي، لتركيز الانتباه على المبادئ المهمة والجوانب التي تستدعي إعادة النظرفيها، ولاقتراح الإجراءات الممكنة لتحسين التعامل الحالي، وذلك ليظهر إمكانها في تحقيق المصالح الاجتماعية والاقتصادية. ويشتمل البحث على فحص موجز عن مفهوم الشركة والمضاربة وأحكامهما، وتحليل مفصل لأوجه مختارة تتعلق بمجالات أربعة للتمويل بالمشاركة عند البنوك الإسلامية هي: رأس المال، والمشاركة في الربح والخسارة، وحسابات الاستثمار، وتمويل المشاريع.

تحت عنوان رأس المال ، تقوم الدراسة بتحليل قضايا مهمة مثل كون رأس المال عينا حاضرا عند الشروع، وتحويل الدين إلى رأس المال، والشركة بالعروض، كما تستكشف نظرية الشريعة الإسلامية في صفة رأس مال الشركة بالتفصيل. وتوضح الدراسة أن طريقة تحديد نسبة الاشتراك في الربح على أساس معدل العائد على رأس المال ومدة الاستثمار تحتاج منا إلى إعادة نظر، وتقترح بديلين على أساس مساهمة الشركاء في كل من رأس المال والعمل، وتحلل الشروط المخلة بوظيفة نسبة الربح. وتحقق الدراسة أثر استرداد المال ومدة الاستثمار على توزيع الأرباح بين المودعين في حسابات الاستثمار، وتؤكد الحاجة إلى نظام لتوزيع الخسارة بين المستثمرين، ثم تقترح بديلا لتكييف حسابات الاستثمار. وتفحص الدراسة أيضا أهم جوانب المشاركة المتناقصة والأبنية الأخرى لتمويل المشاريع على أساس المشاركة، وتوضح أن أسلوب المشاركة يؤدي إلى ضبط عدة أوجه سلبية تتأتى عن هيكل التمويل على أساس الدين.

APPROVAL PAGE

The thesis of Muhammad Abdurrahman Sadique has been approved by the following:

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DECLARATION

I hereby declare that this thesis is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Muhammad Abdurrahman Sadique

Signature ………………………………… Date ……………………

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This writing is dedicated to my parents:

Muhammad Sadique ibn Ahmad Abdullah Marikkar Hajiar
&
Fatimatuz Zahra bint Hakeem Sarail Lebbe Marikkar

May the blessings and mercy of Allah be on them.

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CONTENTS

Abstract ii
ملخص البحث iii
Approval page iv
Declaration v
Acknowledgements viii
Contents ix
List of tables xiv
List of figures xiv
List of statutes xv
Subsidiary legislation xv
Transliteration xvi

CHAPTER ONE: INTRODUCTION 1
Equity financing: an introduction 1
Equity financing in the practice of Islamic banks 5
Problems in implementing equity structures 8
Statement of the problem 14
Hypothesis 14
Literature review 16
Objectives 25
Approach and methodology 26
Methodology in surveying the theoretical framework 26
Methodology followed in the detailed analysis 27
Approach to citing current practice of Islamic banks 28
Citing conventional law perspective 29
Clarification on analysing contemporary Shari'ah approach 31
Scope and limitations of study 32

CHAPTER TWO: THEORETICAL FRAMEWORK OF EQUITY MODES 34
Introduction 34
Mushārakah: Islamic partnership 34
Technical meaning of *shirkah* 35
Legality of *shirkah* 37
Types of *shirkah* 39
Shirkah al-milk 42
Definition 42
Types of *shirkah al-milk* 43
Some rules pertaining to *shirkah al-milk* 43
Shirkah al-ʿaqd – contractual partnership 47
Shirkah al-mufāwaḍah 51
Shirkah al-abdān 52
Shirkah al-wujūh 53
Shirkah al-ʿinān 54
Definition and nature 55
Conditions for the validity of *shirkah al-ʿaqd* 58
Capacity of partners to confer and accept agency 58

Knowledge of the profit ratio 59
Profit being a ratio and not a specific amount 59
Capital being existent (ʻ*ayn*) and present, not debt (*dayn*) or absent 60
Capital being in the form of monetary currency 60
Important rules of *shirkah al-ʿaqd* 65
Ratio of profit and loss 65
Management of *shirkah* 67
Termination of *shirkah* 68
Invalid *shirkah* 69
Muḍārabah: islamic fund management 71
Areas of unanimity on *muḍārabah* 71
Definition of *muḍārabah* 72
Legitimacy of *muḍārabah* 74
Conditions for the validity of *muḍārabah* 77
Capacity of the financier and fund manager to confer agency 77
Capital being in the form of monetary currency 77
Capital being existent (ʻ*ayn*) and not debt (*dayn*) 80
Capital being surrendered to the *muḍārib* 81
Declaring the proportion of profit 82
Profit share being fixed as a ratio of the total profit 83
Loss in *muḍārabah* 84
Conditions pertaining to labour 85
Some important rules of *muḍārabah* 86
Revocability 87
Profits divided only after capital is realised in full 87
Duties of the *muḍārib* 89
Muḍārib's transactions 89
Muḍārib investing with another 92
Expenses of the *muḍārib* 93
Increase and decrease of *muḍārabah* assets 93
Financier withdrawing capital 94
Muḍārabah becoming invalid 95
Conclusions 96

CHAPTER THREE: CAPITAL IN EQUITY FINANCING 99
Introduction 99
Existence and presence of capital 100
Existence of capital at the inception of partnerships and companies 100
Relevance of existence of capital in the context of Islamic banking 101
Shari'ah perspective of existence and presence of capital 105
Knowledge of the amount of capital 112
Initial investment by the client in *mushārakah* with Islamic banks 115
Should the whole capital be made available? 117
Implications of the requirement that capital be available 118
Analysis of the practice of Islamic banks on the issue 120
Contemporary Shari'ah approach 123
Observations on ensuring existence and presence of capital 125
Has the identity of money altered? 126
Converting debt due to a partner into capital 131

Practice of Islamic banks in converting debt ... 131
Shari'ah perspective ... 133
Bank deposits as capital ... 136
Commodities (illiquid assets) as capital ... 139
Islamic banks and equity ventures on illiquid (commodity) capital ... 139
Shari'ah perspective of illiquid capital ... 141
Shāfiʿi perception of *shirkah* and their position on illiquid capital ... 143
Method advocated for practice ... 146
Ḥanafi perception of *shirkah* and their position on illiquid capital ... 149
Ḥanbali perception of *shirkah* and their position on illiquid capital ... 159
Māliki perception of *shirkah* and their position on illiquid capital ... 163
Comparison of the above positions ... 169
Summary of Shari'ah position regarding illiquid assets as capital ... 176
Involvement of the mutual sale ... 177
Application of illiquid capital in equity financing – implications ... 178
The format best suited ... 179
Reclaiming assets at termination of venture ... 182
Conclusions ... 182

CHAPTER FOUR: PROFIT AND LOSS SHARING IN EQUITY FINANCING ... 185
Introduction ... 185
Determining profit and loss sharing ratios ... 186
Relevance of profit and loss sharing in the context of Islamic banks ... 186
Method of determining the profit distribution ratio ... 188
Appraisal of the use of rate of return and period in equity financing ... 191
Ideal ratio ... 195
Determining profit ratio based on capital and labour contributions ... 198
Equal weightage method for capital and labour ... 204
Quantification of labour ... 204
Illustration ... 207
Adjusted weightage method for capital and labour ... 209
Assessing capital and labour weightage ratio ... 210
Illustration ... 211
Comparison of the above methods ... 213
Adjustment of agreed profit and loss sharing ratios ... 216
Relevance of adjusting profit ratio to equity financing ... 216
Shari'ah perspective of stipulating profit and loss sharing ratios ... 219
Allocation of a lump sum to either partner ... 221
Allocation of a lump sum in addition to a proportionate share ... 224
Stipulation on unilateral entitlement to excess profits ... 225
Contemporary Shari'ah approach to the issue ... 228
Observations ... 230
Stipulation reserving right to alter profit sharing ratio ... 234
Shari'ah perspective of revising agreed profit sharing ratio ... 236
Contemporary Shari'ah approach ... 239
Observations ... 241
Conclusions ... 243

CHAPTER FIVE: EQUITY ACCOUNTS WITH ISLAMIC BANKS 246
Introduction 246
Equity accounts among conventional deposit accounts 247
Mechanism of equity accounts 250
Joint equity accounts and *muḍārabah* / *shirkah* contracts 252
Investment in equity accounts 257
Shari'ah perspective of the concept of joint investment 257
Joint investors in *muḍārabah* 258
Mingling capitals invested by different investors 260
Ḥanafi position on mixing funds of different investors together 262
The nature of the fund manager (*muḍārib*) 265
Common management of capital by *muḍārib* through mixing funds 267
Restriction of *muḍārabah* tenure to a specific period 270
Continuity of *muḍārabah* 273
Simultaneous investment by all investors 275
Recognition of profit and loss in *muḍārabah* 277
Difficulties faced in recognising profit and loss in equity accounts ... 280
Withdrawal from equity accounts 284
Withdrawal according to Muslim jurists 286
Withdrawal after realisation of profit 287
Withdrawal after realisation of loss 288
Analysis of the nature of withdrawal discussed by jurists 289
Schemes proposed by contemporary scholars for withdrawal 292
General withdrawals from equity investment accounts 294
General withdrawals according to contemporary scholars 296
Shari'ah analysis of general withdrawals 299
Shari'ah identity of provisional disbursements 302
Capacity of the *muḍārib* to extend loans 304
Distribution of profit and loss in equity accounts 306
Distribution of profit based on capital and duration of investment 310
Illustration 311
Observations on adopting daily product method 314
Lack of precedence 315
General withdrawals directly leading to reduction of profit share 316
Practical implication of disallowing alteration of profit share 319
Inadequacy for loss division 321
Contemporary Shari'ah position on loss division 323
Factors complementing ambiguity regarding loss division 324
Amendments proposed to the current system 329
Conclusions 335

CHAPTER SIX: PROJECT FINANCING ON EQUITY BASIS 338
Introduction 338
Equity based project financing among other financing modes 339
Categories of equity based project financing 342
Decreasing partnership – *mushārakah mutanāqiṣah* 344
Basis of decreasing partnership 345
Varieties 346

Decreasing Partnership for asset purchase: mechanism 348
Operational steps 349
Some Shari'ah issues relevant to decreasing partnership 351
Amalgamation of different contracts together 352
Title to the purchased asset 355
Shari'ah implications of ownership 356
Legal mortgage over the asset in favour of the bank 357
Status of contractual promises 358
Liquidation of mortgage in decreasing partnership 360
Independence of contracts 362
Lease of bank's share to the client 363
Purchase of units by the client 364
Fixing unit prices and *ijārah* rentals 368
Issues on fixing unit price and rental 369
Illustration 371
Amendments proposed to current structure for asset purchase 374
Allowing client the option to purchase or continue lease 377
Decreasing partnership for financing ventures 379
Additional operational aspects in financing ventures 381
Observations on decreasing participation for ventures 383
Issues pertaining to promise to purchase / sell 384
Participation of the bank in the equity venture 388
Legal framework of decreasing partnership 389
Financing trade goods ready for disposal 390
Notable issues involving debt-based structures 391
Equity structure 393
Altering profit ratio due to delay in proceeds 395
Additional costs incurred in disposal of assets 396
Financing procurement of trade goods 399
Debt-based structures for procuring stock 400
Mechanism of *murābaḥah* in Islamic banks 402
Murābaḥah for import purchase 402
Aspects of concern in implementation of *murābaḥah* 403
Equity structure 405
Observations on the equity arrangement 407
Conclusion 409

CHAPTER SEVEN: CONCLUSIONS 411
Introduction 411
Conclusions and recommendations 411
Contributions of the research 425

BIBLIOGRAPHY 428

LIST OF TABLES

Table No.		Page No.
3.1	Existence and presence of capital at inception of venture and commencing operations according to schools of Islamic law	110
5.1	Distributing profits among investors based on daily product method	312
6.1	Unit price and rental in decreasing partnership in the event of irregular payments	372

LIST OF FIGURES

Figure No.		Page No.
2.1	Al-Rāfiʿi's classification of partnership according to its correlation to property (*māl*)	40
4.1	Determining profit sharing ratio based on capital and labour contributed by partners through Equal Weightage Method	208
4.2	Determining profit sharing ratio based on capital and labour contributed by partners through Adjusted Weightage Method	213

LIST OF STATUTES

Banking Act 1973
Banking and Financial Institutions Act 1989 (BAFIA) (Act 372)
Companies Act 1965 (Act 125)
Finance Companies Act 1969
Income Tax Act 1967
Islamic Banking Act 1983 (Act 276)
Real Property Gains Tax Act 1976
Stamp Act 1949

Subsidiary legislation

Guidelines on Skim Perbankan Tanpa Faedah (Interest-free Scheme) 1993

TRANSLITERATION

ء	’	ع	‘
ب	b	غ	gh
ت	t	ف	f
ث	th	ق	q
ج	j	ك	k
ح	ḥ	ل	l
خ	kh	م	m
د	d	ن	n
ذ	dh	هـ	h
ر	r	و	w
ز	z	ي	y
س	s	ـَـ	a
ش	sh	ـِـ	i
ص	ṣ	ـُـ	u
ض	ḍ	ـَـ + ا	ā
ط	ṭ	ـِـ + يْ	ī
ظ	ẓ	ـُـ + وْ	ū

CHAPTER ONE

INTRODUCTION

EQUITY FINANCING: AN INTRODUCTION

Provision of finance could materialise either in a manner where the seeker of funds becomes indebted to the provider, or through extending funds by way of capital participation in a joint venture, where practicable. The first, commonly referred to as debt-financing, includes means of financing such as extension of loans against interest or otherwise, sale on deferred payment, lease etc, where the process leads to the creation of a debt. In the second mode where funds are provided as capital exposed to profit or loss, the liability remains with the provider to the extent of his capital, and no debt is created. This method, which could be called equity financing as it is based on contributing equity, includes Islamic modes of financing such as *mushārakah* and *muḍārabah*. Prior to outlining the plan of the research, it is appropriate to provide a summary of equity financing and its relationship to debt financing mainly from an economic perspective, followed by a review of its application by Islamic banks. This is undertaken below in a succinct manner, as a detailed analysis of the economic aspects does not fall within the ambit of the current research.

Economic ideals propounded by Islam as alternatives to debt financing could be broadly categorised as *qarḍ ḥasan* and equity financing. A large proportion of all business financing in an Islamic economy would be based on equity financing, where the financier shares in the profit and loss of the business financed.[1] *Qarḍ ḥasan* or interest-free loan, the other alternative, is not supposed to play a significant role in

[1] Umer Chapra, *Towards a Just Monetary System,* London, The Islamic Foundation, 1985, 68.

business finance today, as it is not purported to give rise to any material increase directly or indirectly.[2] In financing on the basis of equity participation, the funds required by the venture are injected as equity or capital that is entitled to a share of any profits realised through the venture, while being exposed to erosion or total eradication in the event of loss. The funds increase the equity base of the venture, thus providing stability. The profit and loss both are distributed among all participants who contribute towards the equity, which differentiates this mode of financing from debt financing. Thus, equity financing entails mutual sharing of risks pertaining to the enterprise and an equitable distribution of the return. The actual rate of return of all sharing parties will be determined *ex post* in accordance with the actual performance of the venture.

In conventional debt financing, additional finance sought is injected in the form of a loan at a predetermined rate of interest. The funds injected come as a liability on the venture, which is to be repaid with the interest, according to the terms agreed. The funds do not play any role in increasing the equity base. They remain a foreign element as far as the assets of the venture are concerned, and do not take a constructive share in enhancing the networth. Therefore, even a large amount of funds injected as a debt serves only the purpose of inflating the cash position temporarily. Profit or loss of the venture is borne solely by the entrepreneur, the lender not being immediately concerned with this aspect. Irrespective of the ultimate profitability of the venture, the lender is entitled to receive the agreed amount of interest. Thus, risks are associated with the entrepreneur solely.

---

[2] For a brief and informative explanation of loans and lending in Islam, see Al-Ittiḥād al-Dawli li al-Bunūk al-Islāmiyyah, *al-Mawsūʿah al-ʿIlmiyyah wa al-ʿAmaliyyah*, vol. 5, 203; Muṣṭafā ʿAbdullāh al-Hamshari, *al-Aʿmāl al-Maṣrafiyyah wa al-Islām*, al-Qāhirah, al-Shirkah al-Miṣriyyah li al-Ṭabāʿah wa al-Nashr, 1973, 75.

In profit sharing arrangements, only shares of expected profit are determined at the outset, while the actual rate of return on investments is to be determined in the end, on the basis of realised profits. However, debt, on the other hand, requires predetermined interest payments, and business difficulties may create pressures on the firm's cash flow, forcing it to forgo lucrative business ventures, borrow further, or sell its existing assets. As equity finance does not create such mandatory payment, the cost of adjustment to any contingency is lower.[3] Therefore, proponents argue that in an advanced economy, equity financing should be the rule and not the last resort. Profit sharing provides more flexibility in meeting contingencies, through facilitating a balanced distribution of gains as well as risks among the participants. Conversely, debt is restrictive and unforgiving, hence less stable.[4]

In depositing funds with a bank under an equity arrangement, instead of being guaranteed for the face value of deposits, the depositors here are essentially shareholders whose returns vary with the profits and losses of the bank. The situation could be even compared to accounts in mutual funds. This would render deposit insurance unnecessary, and there would be less likelihood of financial panics or runs. Research in the area of mutual-fund banking comes to the same conclusion.[5] Researchers also observe that under equity financing, assets and liabilities of the bank would move together due to the above reason. This, while relieving banking authorities from excessive regulatory oversight, would result in the net-worth values constantly giving an adequate read on the health of the financial institution.[6]

---

[3] Usamah A Othman, "Debt and equity contracts in the theory of social economy" (1994) vol. 3, No. 1 Review of Islamic Economics 5.

[4] Ibid.

[5] Tyler Cowen, Randall Kroszner, "Mutual fund banking: a market approach," (1990) vol. 10 no. 1 The Cato Journal 227, in Mohammed Akacem, Lynde Gilliam, "Principles of Islamic banking: debt versus equity financing" (March 2002) vol. 9 no. 1 Middle East Policy 124(15).

[6] Akacem, Gilliam, "Principles of Islamic banking ..." above.

In debt financing, the possibility of refinancing brings about an uncertainty for both parties as to the nature of the future terms of the contract. It may even induce the debtor to liquidate to save as much as he can of the present value before foreclosure prevents him from saving his own equity. In a profit sharing arrangement, there is less incentive for this even if the expected average gross rate of return changes, due to the absence of a strict obligation of principal repayment on the entrepreneur. The return to the capital investor will be in accordance with the actual market conditions.[7]

In the equity based risk / reward sharing system, value judgements as well as strength of the proposal would both play an important role in the allocation of resources.[8] Financing of any economic or business activity turns into an ownership stake, and banks have an incentive to make the joint venture work. They become fully involved in overseeing the project and make sure that the money is spent wisely.[9] Similarly, the equity arrangement should encourage the borrower to exert more effort in his endeavour and should lessen the moral hazard problem of underreporting profits.[10] The fusion between investment experience and financial experience found in the Islamic banking system could provide the maximum guarantee for sounder investment through the best possible utilisation of limited resources.[11]

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[7] Othman, "Debt and equity contracts …," 7.

[8] M Umer Chapra, *Islam and the Economic Challenge*, Leicester, The Islamic Foundation, 1992, 332.

[9] Akacem, Gilliam, "Principles of Islamic banking ..." above.

[10] Othman, "Debt and equity contracts …," 8.

[11] M A Mannan, *Islamic Economics: Theory and Practice*, Delhi, Idarah-i Adabiyat-i Delli, 1970, 226.
The Japanese experience could provide a real-time example. By engaging in joint debt-equity finance, the Japanese bank is able to address the agency problem of information asymmetry (Amir Barnea, Robert A Haugen, Lemma W Senbet, *Agency problems and financial contracting*, Prentice Hall, 1985, 38, in Akacem, Gilliam, "Principles of Islamic banking ..." above.) Since the bank is now part owner, it has access to more information on the firm and in turn achieves efficiency gains in monitoring (Sun Bae Kim, "The use of equity positions by banks: the Japanese evidence" (Fall 1991) The Economic Review, Federal Reserve Bank of San Francisco 41, 43, in Akacem, Gilliam above.)

Equity financing in the practice of Islamic banks

Economic ideals advocated by Shari'ah favour a system that leads to an equitable distribution of wealth, avoiding excessive concentration and deprivation.[12] Facilitating equity participation in trade and other undertakings that help the real fruits of ventures spread among a larger segment of the society while dividing the inherent risk is an important facet of an Islamic financial system. As such, a decisive and unambiguous introduction of genuine equity financing modes has been a vital goal in the establishment of Islamic financial institutions.

As far as the conventional system of banking and finance is concerned, despite of certain advantages as could be perceived in the equity mode, the conventional system is founded principally on debt financing. Equity financing is often the last resort. More surprisingly, adoption of equity modes by Islamic banks themselves is noted to be less common than the use of debt-based modes based on various adaptations of mark-up schemes. Several decades after their appearance in the scene of banking and finance, Islamic banks continue to use debt-financing tools widely, and have not so far been successful in implementing equity modes in a significant manner.[13] Debt-based structures frequently adopted by Islamic banks are *murābaḥah*, *ijārah*, *istiṣnā*ʿ, and numerous variations based on these. Application of equity financing modes is seen to be less developed and adopted sometimes in unfavourable conditions where they may not function in a manner that could reveal their full potential.

[12] Qur'anic verses on the division of booty, inheritance, payment of *zakah*, charity and spending of excess wealth etc. allude to this fundamental value. See *Sūrah* al-Ḥashr, 59: 7, and al-Baqarah 2: 219.

[13] For a highly incisive yet succinct appraisal of the issue, see the chapter on "The Perfomance of the Islamic banks – a realistic evaluation" in Muhammad Taqi Usmāni, *An Introduction to Islamic Finance*, Karachi, Idaratul Ma'arif, 2000, 235.

During their formative period, in order to compete with the well-established interest-based banking sector, Islamic financial institutions were hard-pressed to develop a viable scheme compatible with Islamic principles in a relatively short span of time. Due to the special constraints under which they had to operate at the time, Shari'ah scholars had allowed them to resort to some trade oriented products that could serve the purpose of providing a permissible alternative to interest-based financing. Similarly, in employing methods of equity participation, in acquiring funds from investors as well as disbursement to entrepreneurs, aspects pertaining to capital, profit / loss sharing etc were subjected to some modification and amendment in order to facilitate ease of application in different areas of financing. These structures allowed elements of Islamic finance to be introduced in the field of modern banking and commerce in an experimental manner, in harmony with the prevalent norms and operational procedure. In order to win market approval and customer confidence, they were structured in a way that incorporated some aspects of conventional banking, and were planned to diverge from established banking practices only where it was essential. As a result, equity-financing modes employed by Islamic banks in many areas are seen to embody aspects that could be more readily related to debt financing.

Thus, a number of modes currently adapted by Islamic banks for financing purposes have little in common with investment and financing. These modes are not the perfect Islamic substitutes for the interest-based counterparts they are supposed to replace, but happen to be extensions of debt-based products that have been adapted to conform to Shari'ah requirements for financing mediums. While these modes constitute valid means of trading and commerce when utilised in their original contexts, their adoption for financing, often with a number of alterations for their suitability in a banking environment, is not devoid of negative aspects. Regardless of

their admissibility or otherwise, continued operation of these modes could not be expected to realise the fruits of an ideal Islamic economic system, which result from a full-fledged implementation of Islamic equity modes.

Although Islamic banks are allowed to invest in businesses directly in addition to financing third party enterprises, in actual fact, direct investment by Islamic banks is not seen to have flourished due to a variety of factors, not the least among them being the identity inherited from the conventional industry as mere financial intermediaries, and legal impediments resultant of this identity. The tendency found in Islamic banks is to invest in short-term deals, due to the apprehension that involvement in long-term equity projects could affect regular payments of profit to depositors, a necessary aspect in competing with conventional banks. Such aversion to long-term investment reduces the efficiency of Islamic banks in the long run.[14] In the Malaysian context, Islamic banking is concentrated in the individual customer sector and not in commerce and industry.[15] Despite of the fact that short-term financing, involving trade financing and other types, performs an important economic function, such financing does not cause the creation or increase of additional production capital, on which real economic growth rests. Thus, emphasis on short-term financing would not be congruent with social needs.[16]

Due to the persistence of Islamic financial institutions in employing debt-financing structures as the main avenue of business, contemporary scholars have done a considerable amount of work in fine-tuning these and identifying solutions for difficulties faced in their implementation as a universal alternative for all types of

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[14] Saad al-Harran, "Equity Financing" (Nov & Dec 1994) vol. 5 no. 3 The American Journal of Islamic Finance 8.

[15] Nik Mohamed Affandi bin Nik Yusoff, *Islam & Business*, Selangor, Pelanduk Publications, 2002, 55.

[16] Obiyathulla Ismath Bacha, "Conventional versus *muḍārabah* financing: an agency cost perspective" (1995) vol. 4 nos. 1 & 2 Journal of Islamic Economics 35.

interest-based loans. The efforts in this regard have been undertaken to ensure that such financing, although unsuccessful in realising Islamic economic objectives, remains within the broad limitations of the Shari'ah. However, considering the fact that debt financing is never the ideal Islamic alternative, and as such, could hardly be expected to curb the economic evils of the current system, debt-based tools appear to be grossly unworthy of the extensive work carried out by contemporary scholars and the ongoing discussion on the topic.

Problems in implementing equity structures

While some have gone so far as to question the sincerity of Islamic banks in devising workable interest-free alternatives,[17] i.e. based on equity participation, reasons cited by others for the lukewarm interest shown by current-day Islamic financial institutions in implementing equity structures carry some similar themes. A major factor could be that equity financing is commonly perceived as difficult in operation. This perception appears to arise from the conventional banking standpoint, where equity financing is considered specialized business carrying drawbacks such as risk, difficult nature, long gestation period and potential involvement in management.[18] *Muḍārabah* financing is assessed to have more agency problems compared to conventional debt or equity financing.[19] Obligation to oversee projects in which they are partners is another potential deterrent. This requires managerial skills and expertise in overseeing different investment projects.[20] Clients and projects to be financed require more careful evaluation.

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[17] Tarek El Diwany, Muhammad Nejatullah Siddiqi, "A discussion with professor Siddiqi – June 2006," <http://www.islamic-finance.com> viewed on 15.06.2006.

[18] Al-Harran, "Equity Financing," 7.

[19] Bacha, "Conventional versus *muḍārabah* …," 45.

[20] Akacem, Gilliam, "Principles of Islamic banking ..." above.