The terms of musharakah and shirkah

INTRODUCTION:

In today's society entrepreneurs are faced with the problem of how they are going to find funding to promote their new business. The notion behind the religion of Islam is to bring all people together through bonds of love so that everyone feels connected to each other; like they would in a family. This unity spans the world and includes each and every person; no one is discriminated against due to where they live or the race that they belong to. This chapter aims to examine the musharakah framework (equity participation) along with other financing options that the banks of Islam provide.

1. DEFINITION OF MUSHARAKAH & ITS HISTORY.

The terms of musharakah and shirkah are used to denote a partnership of two or more people when they put together either their money or workmanship and then share the profits that are accrued from them. All of the partners will share equal rights to the business. Since the beginning of humanity, the way in which people live has been changing and this becomes more and more apparent through adaptations and revelations in society, the economy, science, culture and politics. As a result of this, fashions change and so do the standards by which people live. All of these aspects affect commercial procedures, which are different according to region. When the religion of Islam first began, financing methods for the Arabian people were very straight forward. When the Holy Prophet came to light, musharakah was already starting to take prime place over other commercial procedures in Arabia. The Holy Prophet authorized musharakah and indeed used it himself. Once the Hijra had taken place, the Prophet announced that the muhajireen and the ansar are brothers. As a result of this, they teamed up in business through musharakah, muzara and musaqat. The transaction, although they varied, were the same. The different classifications in the language of Arabic define procedures like muzara for agriculture, musaqat for gardening and musharakah for trading. Mudarabah is the name given to funding and labour. All four of these types of financing were created to be individual forms and rules and regulations for each one were developed by jurists. The majority of jurists believe that musharakah is a legally binding secure contract in the religion of Islam. There are varying opinions however about the small print in the contracts for them.

Types of Musharakah: Initially Musharakah or Shirkah (Partnership) of two types. Namely:

1. Shirkah al-milk (non-contractual partnership)
2. Shirkah al-uqood (contractual partnership)

1. Shirkah al-milk(non-contractual partnership) implies co-ownership and comes into existence when two or more persons happen to get joint-ownership of some asset without having entered into a formal partnership agreement; for example, two persons receiving an inheritance or a gift of land or property which mayor may not be divisible. The partners have to share the gift. or inherited property or its income, in accordance with their share in it until they decide to divide it. If the property is divisible and the partners still decide to stick together, the shirkah al-milk is termed ikhtiyariyyah (voluntary). However, if it is indivisible and they are constrained to stay together, the shirkah al-milk is characterized as jabriyyah

(involuntary). Shirkah al-uqood(contractual partnership) can, however, be considered a proper partnership because the parties concerned have willingly entered into a contractual agreement for joint investment and the sharing of profits and risks. The agreement need not necessarily be formal and written; it could be informal and oral. Just as in mudarabah, the profits can be shared in any equitably agreed proportion. Losses must, however, be shared in proportion to the capital contribution.

2. Shirkah al-uqood (contractual partnership) hasbeen divided in the fiqh books into four kinds: al-mufawadah (full authority and obligation); al-inan (restricted authority and obligation); al-abdan (labor, skill and management); and al-wujuh (goodwill, credit-worthiness and contracts). In the case ofmufawadahthe partners are adults, equal in their capital contribution, their ability to undertake responsibility and their share of profits and losses. They have full authority to act on behalf of the others and are jointly and severally responsible for the liabilities of their partnership business, provided that such liabilities have been incurred in the ordinary course of business. Thus each partner can act as an agent (wakil) for the partnership business and stand as surety or guarantor (kafil) for the other partners. Inanon the other hand implies that all partners need not be adults or have an equal share in the capital. They are not equally responsible for the management of the business. Accordingly their share in profits may be unequal, but this must be clearly specified in the partnership contract. Their share in losses would of course be in accordance with their capital contributions. Thus in shirkah al-inan the partners act as agents but not as sureties for their colleagues. Shirkah al-abdanis where the partners contribute their skills and efforts to

the management of the business without contributing to the capital. Inshirkah al-wujuhthe partners use their goodwill, their credit-worthiness and their contacts for promoting their business without contributing to the capital. Both these forms for partnership, where the partners do not contribute any capital, would remain confined essentially to small-scale businesses only. These are of course models. In practice, however, the partners may contribute not only finance but also labor, management and skills, and credit and goodwill, although not necessarily equally.

Types of Modern Musharakah and its Conditions: The modern business concerns being run on the basis of musharakah (as defined above) are as under:

1. Partnership: It is regulated by-
   1. Partnership rules framed by the government.
   2. Business practices prevailing in the business community.
2. Limited company: This type of musharakah is strictly controlled by the statutory rules framed by the government its commercial activities are, however, influenced by the business practices (urf).
3. Co-operative societies: This musharakah is also governed by statutory rules. Its commercial activities are influenced by the practices prevailing in the business community.

Equity Financing

In Islam economy, there are two types of finance options; definite and indefinite. Indefinite lasts for an unknown duration, like that of the stock markets and definite is for a definitive amount of time but may be either short term or long term, such as a loan. Money that is borrowed is based on the notion of profit-and-loss sharing, not interest and therefore falls into the category of temporary equity and runs out on a specified date. As with equity capital, temporary equity does not benefit from having rights to any business assets, as does qard al-hasanah. As the money cannot be secured on any assets, the banks and financers may perhaps be more dubious to lend money and may assess businesses in more detail. Furthermore, in the Islamic economy, it is hard to secure longer term financing without surrendering part of the business. If the business grows, then the ownership of the business has to be redistributed. In the same way, it is impossible for people to gain money from savings without being forced to take on responsibility for threats that face the business. Therefore, in the Islamic economy, threats and gains from a business are more commonly dealt out than is viable with capitalism. Borrowers can be put into three categories; private sector investors, who need money to grow their business; private sector borrowers who require financing for their consumption requirements; governments who need to fill in gaps of their budget. The question under light is whether the requirements of these three types of borrowers are met with the equity financing model. In this chapter, private sector equity will be discussed in more detail; how equity financing can be used to fulfill the requirements of consumers and governments.

Channels of Equity in Islamic Society: Islamic banking is equity-oriented and the Islamic instruments of financing would ideally be based on profit and loss sharing. This would bring a fundamental change in the role of Islamic banks and would convert them from creditors to partners. The channels that equity investment may take in an Islamic society are the same as elsewhere, namely, sole proprietorship, partnership (including both mudarabah and musharakah) and joint stock companies. Cooperation can also play an important role in an Islamic economy because of its harmony with the value system of Islam and the valuable contribution it can make to the realization of its goals.

(i) Sole ProprietorshipGenerally speaking, the entrepreneur depends essentially in this case on his own finance and management He may be able to supplement his financial resources by supplier’s credits which played an important role in Muslim society in the past and tends to be a major source of short-term capital.

(ii) Partnershipit is the relationship which exists between two or more persons carrying on a business in common with a view to profit. The definition provides us with three requirements for a partnership in that there must be a business, that it must be trading (carrying on), and that it must have the capability of making a profit. Partnership in an Islamic society may take one of two juristic forms, mudarabah or musharakah. The Islamic jurists have proposed other forms of partnership to provide credit and finance for Agricultural, manufacturing and trading purposes. These are:

(1)Consecutive Partnership: This instrument of financing is a real innovation on the part of the Islamic banks. The formula is used as a basis for the distribution of profits among depositors, who, in Islamic banks, hold a middle place between shareholders of equity on the one hand, and depositors and or lenders on the other.

(2) Agricultural Partnerships: Privately owned agricultural land could be exploited in one of the three ways: (a) directly by the owner, (b) indirectly by renting it (ijara), (c) through agricultural partnership. The two main frameworks in traditional Islamic law for agricultural enterprise are (a) muzara' a (share cropping) and musaqat (water partnership or tree-sharing). Both these techniques typically afford a partnership between capital and labor.

Mudarabah and musharakah were the basic methods, by which financial resources were mobilized and combined with entrepreneurial and managerial skills for purposes of expanding long-distance trade and supporting crafts and manufacture. They fulfilled the needs of commerce and industry and enabled them to thrive to the optimum level given the prevailing technological environment.

Steps to be taken to transform to an Equity Financing System

As previously stated, if interest is eliminated, all companies in Islamic countries that are based on a combination of equity and interest loans would need to become solely based on equity. This means that all financial requirements in the Islam economy, that are indefinite, either fixed or working capital in nature, are supposed to be come from equity capital. This wider equity capital base may perhaps be sustained by intermediate and long term mudarabah advances. Loans that are short in nature may sometimes only be used as a temporary measure. There are a number of things that need to be done to change the equity based finance schemes in Islam countries.

First of all, projects should be chosen for financing based on their partnerships and how much profit they are going to make instead of the trustworthiness of the person who is borrowing the money.

This, coupled with the prevalence of equity markets and the lack of debt markets, has brought Muslims academics to the conclusion that in Islamic schemes, there will be; a higher level of business ventures that require funding; a more secure scheme with the lenders, of choosing ventures to finance; a higher level of participation from society in carrying out business ventures. Secondly, so that companies can raise their equity, the level of money that has come about due to tax evasion may need to be standardized. Doing this should increase the amount of money that can potentially be lent. The following chapter will look into this issue in more detail. The area of focus will be the Middle Eastern stock markets.

Third of all, there is a need for tax legislations to be altered so that they are the same as those for dividends and profits. Fourthly, the tax system in Islamic countries should be revised to that more people are willing to invest. Finally, the creation of suitable of suitable financial schemes and investing banks should be motivated to make venture capital obtainable to companies and manufacturing firms and therefore allow them to take on essential investments. In the procedure they would also give savers the chance to invest, such as those who cannot find suitable projects themselves and those who need a partner or mudaribs.

The Role of Equity Financing in Mobilizing Funds and Stabilization of the System

Given the importance Islam places on equity financing, there should be a stronger will to save money to invest in personal businesses. If there are gainful opportunities for investment that cannot be taken advantage of by depending solely upon interior cash injections, business owners can rent properties or equipment.

Joint stock companies could also be very useful in the Muslim economy; passive investors could have access to their shares. In capitalist economies, corporate equity makes up a large proportion of funding. In an Islamic economy, it is always achievable for a person to expand and decrease his risks by making financial institutions and investment trusts a vehicle for his investment because such organizations expand their own risks by efficiently controlling their contacts with different areas of the economy, like individuals and companies do. It must be understood that the gains on equity in an Islamic economy will not be equivalent to profit but will be the result of what makes interest together with profit in the capitalist economy; this is named return on capital. It will comprise of the returns for saving and risky business and entrepreneurship, management and innovation.

Therefore the Islamic organizations should be able to make sure that fairness between the entrepreneur and the lender exists. No one would be guaranteed of a prearranged level of return. One must recognize the threats and split the products of the business. This may not automatically modify the total outcome. It would indeed alter the allocation of the total result in agreement with the Islamic model of socio-economic fairness. It would also eradicate the irregular and illogical variations between the shares of the investor or banker and the entrepreneur. Therefore circumstances where the savers experience hardship (if interest is little and profit is elevated) or the entrepreneurs experience hardship (if interest is elevated and profit is small or negative) would be eradicated and justice would be generated between the two. The result of this should be good for both parties. The removal of interest and its substitution by profit-loss-sharing would not only alter the amount of doubt in people's minds. It would furthermore, by taking away the everyday undermining pressures of changing interest rates, create a commitment of finance for a longer time and also initiate regulations in investment choices. In such circumstances, the power or weakness of a currency would be likely to be reliant on the basic power of the financial system, particularly the rate of price rises, and exchange rates. Together with by the Islamic focus on interior solidity in the worth of money, exchange rates should show to be more constant because all other features that control exchange rates, such as cyclical progressions, structural disparity and variations in increase rates, are of a long-run format and manipulate anticipations about long-term movements in exchange rates. In the Islamic organization, no such unsteadiness survives when a bank, rather than issuing fixed liabilities, issues shares to its depositors.

When this happens, assets gained by the banks are obvious to shareholders; they are no more or less than the deposits supporting them. If the bank's assets decrease in value, then it will not be in the interest of saver to take out their money because their share would lessen as a result. Moreover, the wellbeing of a saver does not rely on the acts of other savers because the banks value is divided up. There is more motivation actually to stay with the bank when it experiences a decline in the worth of its assets as this would mean acknowledging a loss on the original investment. Possibly the most positive benefit of such a scheme is that it not only stops customers from panicking customers but it also does not need deposit insurance.

Other Financial Instruments of Islamic Financing:

The Islamic banks are engaged in developing various instruments of financing which not only conform to the Islamic tenets of equity and fairness but will also stand the test of day to day business, corporate needs of the modern world and the sophisticated tools of scientific analysis. The Islamic banks have identified and developed a relatively broad range of business and banking contracts. These include:

Ijara (Leasing) Definition and its Advantages:

Ijara means a lease contract as well as a hire contract. In the context of Islamic banking it is a lease contract under which the bank of financial institution leases equipment or a building to one of its clients against a fixed charge.

Murabaha (Cost Plus Financing):

Murabaha is generally defined as the sale of a commodity for the price at which the vendor has purchased it, with the addition of a stated profit known to both the vendor and the purchaser

Qard al-Hasanah (Beneficence Loans):

Qard al-hasanah means an interest-free loan, which is the only loan permitted by shariah principles. Funds are advanced without any profit or charge for humanitarian and welfare purposes.

Bai Muajjal (Deferred Payment Sale):

This transaction allows the sale of a product on the basis of deferred payment in installments or in a lump-sum payment. The price of the product is agreed to between the buyer and the seller at the time of the sale and cannot include any charges for deferring payments.

Bai Salam (Purchase with Deferred Delivery):

In this transaction the buyer pays the seller the full negotiated price of a specific product which the seller promises to deliver at a specified future date. This transaction is limited to products whose quality and quantity can be fully specified at the time the contract is made.

Tadamun or Takaful (Solidarity):

Takaful literally means “ mutual guarantee”. In the context it is the Islamic answer to the modem concept of insurance, which is one of the most important subjects among scholars. This type of contract represents Islamic insurance based on a collective sharing of risk by a group of individuals whose payments are akin to premiums invested by the Islamic banking institution in a mudarabah for the benefit of the group.

Conclusion

These two chapters it has been shown that mudarabah and musharakah are the basic principles by which financial resources are activated and linked with entrepreneurial and managerial abilities to increase long-distance trade and support crafts and production. They meet the needs of business and allow them to perform at their best, given the great resources. These financial tools together with others that have previously been mentioned make up an important characteristic of both trade and industry and offer a structure for investment bin a contemporary Islamic economy. In summary, an Islamic banking system is fundamentally an equity-based scheme in which savers are dealt with like they are shareholders of the bank.

As a result, savers are not assured of the nominal value, or a prearranged rate of return, on their deposits. If the bank makes revenue then the investor (depositor) would be have the right to be given a specific amount of that. On the other hand, if the bank makes a loss, the shareholder experiences this also. Therefore, from the depositor’s viewpoint, an Islamic commercial bank is comparable to a joint fund or investment trust. In addition, to stay consistent with religious views, the bank cannot charge interest on money that it lends but has to use particular methods of investment and funding that are also based on the notion of profit and loss sharing schemes. Unit trusts and investment trusts undoubtedly vary. The worth of shares in an investment trust is controlled in the stock market. In the case of a unit trust (for example, the United States) the value is based on shares in the market. It is not the market worth that is important with Islamic deposits as they aren’t any. Nor is it the underlying value of the assets which the bank has invested in unless there are deposits. What is important is the productivity of the asset values of shares does not always mirror profitability. Profit/earnings ratios can differ greatly and the market acknowledges this. Resemblance with unit trusts is linked to the doubt regarding returns and the value of

Islamic deposits. However, in reality value hardly ever changes, which is not the case with unit trusts where it is controlled by the market. Normally, Islamic deposits are less dangerous than unit trust holdings. Income oriented unit trusts are most effortlessly contrasted to the Islamic deposits and not trusts which are growth based. With regards to this, there is much uncertainty in the Islamic texts concerning finance.