In this section we discuss various equity-based financing products, such as, mudaraba and musharaka. In banking parlance, these are referred to as trustee project finance and joint venture project finance respectively. The former involves a combination of entrepreneurship and capital while the latter involves a partnership in entrepreneurship and capital. We also discuss products based on a novel concept of declining musharaka leading to complete ownership of asset or project by the customer-entrepreneur. These equity-based products are unique to Islamic banking and in some sense, account for its superiority over conventional banking on grounds of ethics and efficiency. Arguably, because of their uniqueness, they are also less popular. The equity-based financing is what makes the business of Islamic banking more challenging.

**Trustee Partnership (Mudaraba) Facility**

Trustee partnership based on mudaraba is a mode of financing through which the bank provides capital finance for a specific venture indicated by the customer. The bank, called rabb-al-mal is the owner of the capital and the customer-entrepreneur, called mudarib, is responsible for the management of the business and provides professional, managerial and technical expertise for initiating and operating the business enterprise or project. Profit is shared according to a pre-agreed ratio. Losses if any, are entirely absorbed by the
capital provider – the bank. Mudaraba may be of two types – restricted or unrestricted. In a restricted mudaraba (mudaraba al-muqayyada) the bank or the financier may specify a particular business in which investments may be undertaken. Mudaraba may also be an unrestricted one (mudaraba al-mutlaqa); in which case the mudarib may invest the capital provided in any business he deems fit. A simple mudaraba financing structure is presented in Exhibit 5.1.

Dotted line indicates flow of funds
Activity 1: Bank and Client discuss business plan; Bank provides funds to client towards capital investment;
2. Client sets up the business and manages its operations;
3. Business generates positive or negative profits;
4. Profits if positive, are shared between Client and Bank as per a pre-agreed ratio;
5. Profits if negative, are absorbed by Bank; effectively bringing down the value of the asset created with its investments

Exhibit 5.1 Mudaraba Financing Structure
Joint Venture (Musharaka) Facility

A joint venture based on musharaka involves a partnership in which both the bank and its customer-client contribute to entrepreneurship and capital. It is an agreement whereby the customer and the bank agree to combine financial resources to undertake any type of business venture, and agree to manage the same according to the terms of the agreement. Profits are shared between the bank and the customer in the pre-agreed ratio. Losses are shared strictly in proportion to their respective capital contributions. A simple musharaka financing structure is presented in Exhibit 5.2.

Activity 1: Client and Bank discuss business plan and jointly contribute to capital of the venture;
2. Client and Bank jointly set up the business venture and manage its operations, sharing the responsibilities as per pre-agreed terms; Business generates positive or negative profits;
3. Profits if positive, are shared as per a pre-agreed ratio;
4. Profits if negative, are shared in proportion to capital contributions; effectively bringing down the asset value while keeping their respective shares in it unchanged.

Exhibit 5.2 Musharaka Financing Structure
Issues in Product Management

Risk and Return

*Mudaraba* and *musharaka* are equity-based products that involve sharing of returns and risks. Returns may accrue in the form of periodic profits and change in the value of the assets. An important feature of *mudaraba* is a pre-agreed ratio in which profits are to be distributed between the financier-bank and the entrepreneur-client. It rules out any allocation of profits in absolute terms other than as per the agreed ratio. The same holds good for *musharaka* as well.

Losses in a *mudaraba* are completely absorbed by the financier-bank. The client-entrepreneur is liable to bear losses, if such losses are the outcome of his managerial negligence or misconduct. In *musharaka* however, both the bank and the client share in the losses in the ratio of their investment in the project.

*Mudaraba* also provides for limited liability for the financier in line with the modern equity contract. The liability of the bank is limited to its investment in the project. This is quite rational and fair, since the bank does not participate in the managerial decision-making and cannot be held responsible for the risks created by the entrepreneur-client. *Musharaka* on the other hand, involves unlimited liability of the partners, as both the bank and its client are decision-makers in the business. Therefore, if the liabilities of the business exceed it’s assets and the business goes into liquidation, all the exceeding liabilities shall be borne *pro rata* by the partners.

Regarding change in the value of assets created under *mudaraba*, the client-entrepreneur can neither benefit nor lose because of such change. Such gains or losses accrue solely to the financier-bank. In *musharaka*, however, such gains or losses in the value of assets financed by the joint pool of funds rightly accrue to both the bank-financier and client-entrepreneur.

Liquidation

A feature of the classical *mudaraba* and *musharaka* is that either of the parties to the agreement have an option to terminate the agreement or withdraw from the venture any time they deem fit. Liquidity of investments is thus ensured for the partners. On the date of termination, profits are determined as the excess of the liquidated value of all assets over investment. Once profits are so determined, these are distributed between the parties according to the agreed ratio.
This however, is somewhat problematic for projects that require a certain minimum time period before coming to fruition. It is also problematic in case of projects that are “going concerns”. Withdrawal of a partner from the project may have material consequences for the project. At the same time, the partners need to be provided with liquidity of their investments in the project. Therefore, modern day scholars have devised the concept of “constructive liquidation” which may be practiced with the mutual consent of all parties. The concept implies that the Net Asset Value of the venture may be calculated at periodic intervals by subtracting all liabilities from the asset value. An investor or partner would now be allowed to liquidate its investment at this value.

Combination of Mudaraba-Musharaka

Often a mudaraba may be combined with musharaka. In such a facility the client-entrepreneur contributes to the capital of the venture, as does the bank-financier. Like any other mudaraba the client-entrepreneur is solely responsible for the management of the business and the bank is purely a sleeping partner. The catch here is: the ratio of profit share for a pure financier (who does not participate in the management and operations of the business) is capped at or cannot exceed the ratio of its contribution to capital of the venture.

Declining Musharaka

A declining musharaka is a recent innovation. Its popularity originates from the fact that classical musharaka aims to involve bank as a permanent partner in the venture. This may not be a desirable idea for a financial intermediary. A financial intermediary likes liquidity in its investments or at least a finite maturity of its investments. In a declining musharaka, the bank’s share in the equity is diminished each year through partial return of capital. The bank receives periodic profits based on its reduced equity share that remains invested during the period. The share of the client in the capital steadily increases over time, ultimately resulting in complete ownership of the venture. A simple declining musharaka financing structure is presented in Exhibit 5.3.

Issues in Product Management

Forward Commitment

A major issue in design of products based on declining musharaka is related to the forward nature of some activities that are part of the mechanism. While a financier would prefer a forward “commitment” and certainty about the
price at which it could offload its share of investment, this may not be permissible in the framework of Islamic finance.

Activity 1. Client and Bank discuss business plan and jointly contribute to capital of the venture;
2. Client and Bank jointly set up the business venture and manage its operations, sharing the responsibilities as per pre-agreed terms; Business generates positive or negative profits;
3. Profits if positive, are shared between Client and Bank as per a pre-agreed ratio; the profit share of Client flows into Bank too, towards partial redemption of the latter’s capital contribution;
4. Profits if negative, are shared between Client and Bank in proportion to their respective capital contributions; effectively bringing down the asset value while keeping their respective shares in it unchanged.

Exhibit 5.3 Declining Musharaka Financing Structure
It is not without reason that the housing sector has witnessed greater use of declining musharaka than any other sector, since the expected profits from this business would be sourced from rentals that are predictable to a considerable degree. Housing finance through declining musharaka involves joint purchase and ownership of the property by the bank and its client. Once the future rentals and hence, the respective profit shares of the parties are determined, the next step is to require the purchase or redemption of the bank’s share in the asset in future time periods. The common view is that Shariah does not permit forward purchase or sale involving commitment from both parties, but allows a unilateral promise. As such, the client may make unilateral promise(s) to purchase or redeem the bank’s share on specific dates in future. Such promise(s) may also be binding on the promisor.

Pricing of Redemption

Another related issue is the pricing or valuation of such shares. In this matter, the general view is that the redemption should be undertaken at the prevailing market price of the property. While the promise to redeem the shares at “known” or predetermined prices is more convenient, it is more controversial too. If prices are predetermined, this may involve a “certain” return for the financier or open the doors of riba. The counter view is that a promise to buy in future already involves uncertainty. A promise to buy at an unknown (market) price involves still greater levels of uncertainty. Hence, a predetermined price such as cost price may be desirable. In the property financing product by Abu Dhabi Islamic Bank (see Concepts in Practice 5.1), the bank would stand to gain if property prices appreciate in future, as they do in most cases. Instead it opts for sale of its stake at cost price. Clearly, there is a trade-off between risk and reward.

Concepts in Practice 5.1

The property is bought jointly by the Bank and customer. This structure is similar to Ijara in that the customer agrees to pay the cost price over a time period to the Bank, in return for acquiring the Bank's share in the property and paying rent in the meantime for living in the property. The rent element is determined by agreement between the parties based on market rent for similar properties. This structure assumes that, initially the property will be bought at cost price from the seller jointly by the Bank and the customer. The customer promises to purchase the Bank's share over a period of time. The Bank may authorize the customer to register title in his own name and safeguard its interests by holding the title deeds and registering a charge. Repayments are made up of the rent for the property and repayment of a part of the Bank's share of the cost price. As more of the property is being bought by the customer over time, the amount of rent payable is reduced progressively.

Source: www.adib.co.ae
Gharar in Contractual Structure

Standard texts of *Fiqh* mention about inadmissibility of “two contracts in one” on grounds of excessive *gharar*. This essentially stresses the need to avoid unduly complex contractual mechanisms and structures involving multiple interdependent and interrelated contracts. Combining several contracts, such as, adding sale contract(s) or promises to the original *musharaka* contract may cause such complexity. However, in a structure where the sale or option (promise) is in the nature of a separate or side agreement, not linked to the *musharaka* agreement, there is no room for *gharar* caused by interdependence.

Areas of Application

**Project Finance:** *Mudaraba* facility is observed to be a useful mode for financing projects, such as, real estate and housing development, construction of public roads, ports, markets, buildings, corporate plants, warehouses, and other infrastructural concerns. *Musharaka* is suitable all the above projects. In fact, it is suitable for financing any kind of business venture, manufacturing, trading, and others where the bank is willing to act as partner in the venture (see *Concepts in Practice 5.2*).

**Concepts in Practice 5.2**

<table>
<thead>
<tr>
<th>Project Finance Schemes at Al-Amanah Philippines</th>
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<tr>
<td><strong>Trustee Project Financing:</strong> This scheme is designed particularly for awarded projects that need full financing. Under this arrangement, the client utilizes the funds of the Islamic bank to bankroll the completion of a government or corporate project. In return a pre-arranged share of the profit derived from the project is assigned to the client. The ratio of profit sharing may be tilted in favor of the Islamic bank being the sole financier of the project cost and, in some instances, also the project sourcing party. Funds made available by the Islamic bank under this financing mode are usually used to defray the cost of the real estate and housing development, construction of public roads, ports, markets, buildings, corporate plants, warehouses, and other infrastructural concerns.</td>
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<tr>
<td><strong>Joint-Venture Project Financing:</strong> This mode of financing serves the need of clients whose available funds are not sufficient to defray the cost of awarded projects. Under this scheme, both the Islamic bank and the client share the capital formation of the venture according to the pre-arranged ratio. Both partners to the venture also agree upon the ratio of profit sharing. This financing arrangement is also applicable to projects mentioned in trustee projects mentioned in Trustee Project Financing. The Islamic bank may or may not participate in the management of the project. The ratio of profit sharing in this case is usually titled in favor of the active or Managing Partner who is usually the client.</td>
</tr>
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</table>

**Letter of Credit:** In addition to financing of projects, *musharaka* may also be undertaken to finance a single transaction. A useful application of *musharaka* financing is the Islamic letter of credit (see *Concepts in Practice 5.3*).

**Concepts in Practice 5.3**

An Islamic letter of credit at *Al-Amanah* involves the following steps:

- The customer informs the bank of his Letter of Credit requirements and negotiates the terms and conditions of joint-venture financing.
- The customer places a deposit with the bank under *al-wadiah* principle towards his share of the cost of goods to be purchased/imported as per *musharaka* agreement.
- The bank establishes the Letter of Credit and pays the proceeds to the negotiating bank utilizing the customer’s deposit together with its own share of financing, and eventually releases the pertinent papers to the customer concerned.
- The customer takes possession of the goods and disposes these off in the manner agreed upon.
- The bank and customer share in the profit from the venture as provided for in the agreement.


**Housing Finance:** A survey of diminishing *musharaka* financing at various Islamic banks reveals that it is used primarily in the area of housing finance.

**Microfinance:** It is also observed to be potentially quite promising in the field of microfinance or financing of small and medium enterprises.