Financing Trade Asset Procurement and Disposal on Joint Equity Basis for MMES: An Analysis of Some Vital Shariah and Operational Aspects

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Abstract

Debt financing arrangements utilised in financing trade goods and produce ready for disposal, usually based on structures adapted from factoring mechanisms, involve shortcomings from a shariah as well as a commercial perspective. Financing MMES that have stocks ready for disposal could be advantageously carried out on equity basis. Measures that result in altering the agreed profit sharing ratio merely in view of the financial interests of one party could affects the consistency of equity relationships. Recognising additional costs incurred during the equity relationship as infusion of additional capital could lead to anomalous outcomes. Treating such expenses as debts incurred by the venture for which the partners are jointly liable could be more preferable from a shariah perspective. In financing asset procurement for MMES, debt instruments appear especially inadequate. Adopting the equity structure as a comprehensive scheme embracing all stages from procurement of assets until their disposal, could help rectify some shortcomings inherent to debt financing arrangements.

Introduction

Largely due to the established precedent set in place by the conventional banking system, debt-financing tools appear to be the preferred mode in many areas of project financing. However, except in instances such as where funds are needed for consumption or utility purposes, equity based arrangements could be used in a large number of situations, especially those involving venture capital. Unilateral funding modes such as mudarabah as well as common equity participation by the bank and the entrepreneur both are adopted by Islamic banks in this regard. Decreasing equity partnership (musharakah mutanaqisah), a combination mode widely resorted to in house financing, is increasingly becoming popular in other areas of project financing. In addition to financing complete projects, short term finance in the form of financing specific projects of a limited nature and financing of single transactions of purchase and sale could be carried out on an equity basis, where the procedure is relatively less complicated than debt based modes.

Foreign trade, overall, is still carried out by many of the Islamic banks on murabahah. However, this is an area where implementation of equity financing modes could lead
to a more mutually satisfying distribution of gains as well as liability. In addition, it could pave the way to solving many of the difficulties that are experienced currently due to a forced application of murabahah in spite of the indefinite nature of the bank’s ownership over the goods based on documents transfer, and the involvement of foreign exchange conversions. In many cases of import and export involving production requiring several murabahahs, the whole process could be converted into a single equity venture, with some adjustments.

In financing MMEs too, when Islamic banks do consider financing them, mostly debt-financing tools are favoured, excluding certain areas. However, equity based structures could be used in a variety of areas of MME financing. In addition to a more mutually satisfying distribution of gains as well as liability, an attempt to adopt the equity basis could pave the way to solving many of the difficulties that are experienced currently due to a forced application of murabahah and other debt-based alternatives. Equity based financing arrangements for MMEs need not be restricted to funding full-scale ventures through modes such as decreasing partnership. The current paper focuses on employing equity based formats as a stand-alone mode for facilitating project finance, especially for disposal of ready-made stock as well as joint procurement of goods for ultimate disposal, and attempts to shed light on some selected issues relevant to short term MME financing.

**Categories of equity based project financing**

For ease of treatment from a shariah perspective, financing of projects for both short and long terms, overall, could be divided into certain major categories. These are relevant to financing MMEs as well. The first category involves long-term financing of ventures where equity participation is sought from the bank, extending from setting up the venture up to it becoming a successful enterprise generating profits. The bank here may remain an equity partner on a permanent basis, or could disengage from the venture when its participation is no longer necessary. The remaining categories pertain to equity financing of ventures for shorter durations, through participation in single transactions or otherwise. Thus, the second category could be specific to ventures where the client has a ready consignment that needs to be financed. Here the client, after having procured the commodity necessary for sale through any mode such as production, construction, local purchase, import etc. wishes to enter into an equity partnership with the bank for obtaining liquidity until the consignment is disposed of through a mode such as sale, export, and lease, and the returns realised. The third category includes situations where the client is not in possession of assets for disposal. Thus, the assets have to be procured through means such as purchase, manufacture, construction, and import, for subsequent disposal through sale, lease, export etc. Therefore, the equity participation required of the bank here envisages procuring the assets, in addition to their disposal. It is evident that while the involvement of the bank in this type is more than the second category above, it could
even be for a prolonged duration where the assets are to be manufactured or constructed, thus falling under the first category. Another category could comprise instances where short term involvement of the bank is sought for meeting liquidity contingencies faced by a running venture. Here funds sought are not for asset financing or the sale or lease of products, but for running expenses such as wages, overheads etc. This could come under working capital financing.

Therefore, according to the broad classification above, the major types of ventures where equity financing could be applicable are, financing venture capital, financing trade goods ready for disposal, financing procurement of trade goods, and financing working capital. Although, as pointed out before, the above classification may not include all areas of commercial transactions, it could facilitate a general analysis of the shariah aspects pertaining to many types of equity financing. In what follows, methods of financing trade goods ready for disposal and financing procurement of trade goods on equity basis are explored.

**Financing Trade Goods Ready for Disposal**

This refers to financing trade goods that have already come into the possession and ownership of the client. This may include diverse situations such as goods produced by manufacturers that are ready for sale or export, buildings and houses constructed awaiting sale or lease, and merchandise purchased that are to be sold or exported. Finance required by the owner could be for paying outstanding dues resulting from their procurement, or for replenishing his liquidity after having paid or incurred expenses for the goods, until proceeds are realised through their disposal. From a shariah perspective, the distinctive features of importance here could be identified as two. The first is that the client, already having title to the assets requiring financing, the stage of procurement has already come to an end. The second feature of importance is that the goods may bring revenue through their sale or lease. When financing projects that have reached this stage takes the form of equity participation, a structure based on musharakah could appear best suited. This is in view of the fact that the assets are to be disposed of through sale, enabling sharing of proceeds.

**Notable issues involving debt-based structures adopted for financing available stock**

In the customary practice of Islamic banks, in addition to equity-based structures, several debt financing arrangements too are utilised in such instances. These involve various arrangements adapted from factoring mechanisms, which essentially comprise of the purchase of the ready assets from the client against immediate payment, thereafter appointing him as the agent of the bank for their sale to regular clients, against cash or on deferred payment basis. The net proceeds through the sale after settling costs incurred by the client in carrying out the sales on behalf of the
bank would be claimed by the bank. While theoretically, such a structure could be validly conceived, albeit with observance of general conditions applicable to all contracts of sale and agency such as the contracts not being conditional to each other, proper identification of the subject matter, the prices being definite and mutually agreed etc, practical implementation poses serious problems pertaining to their shariah validity.

Some possible issues of shariah relevance arising in implementation could be enumerated as follows. The bank’s purchase of the goods usually takes place only when a confirmed order is available for the consignment, as the profit element for the bank is calculated on the basis of the price receivable from the onward sale and the period of payment. In this event, the bank’s purchase being unrelated to the subsequent sale to the ultimate buyer is established only in a theoretical manner. The confirmed order placed by the ultimate buyer sometimes involves elements that dictate the transfer of the goods’ ownership to him, occasionally supported by payment of part of the price in advance. Due to the prior agreement in place between the bank and the client, such goods are purchased from the client and sold onward through agency in a routine manner, despite of the fact the ownership of the goods had already passed on to the ordering party. The exchange of offer and acceptance is subject to delays, which may even take place after the goods had been dispatched to the final buyer. The separation and identification of the consignment purchased by the bank are prone to errors, especially when different lots of a single order are financed individually. Subsequent to the purchase of the bank, taking possession of the consignment often fails to materialise, mostly due to insufficient attention paid to this aspect. Apart from the purported understanding between the bank and the client that consignments purchased by the bank would become the bank’s property, to be handled by the client thereafter only in the capacity of an agent for sale, such demarcation of different capacities is not considered important by clients. Thus, ensuring the bank’s liability of the goods proves unfeasible in practice. All in all, apart from some documentary and pricing aspects, implementation of practical details of relevance pertaining to the occurrence of two distinct contracts of sale hardly materialises in an acceptable manner. Obviously, employment of such debt-based arrangements could only be acceptable when shortcomings similar to the above are avoided. Therefore, such structures may be adopted only in marketing distinct assets such as houses and buildings, as substitutes for murabahah where needed, with the observance of necessary guidelines.

**Equity structure**

If financing assets ready for disposal is to be done on equity basis, this could be conveniently carried out based on musharakah, as is in vogue mainly in exports against letters of credit. This practice may be adopted in other instances involving ready stock as well. Here, a specific musharakah transactional agreement is drawn on
the particular consignment of assets, where the financier is introduced as a joint owner of the asset as well as a joint investor, who enters into a partnership with the original owner for the sale of the asset and jointly sharing the proceeds. In case a general agreement for entering into such transactions is already in place, the specific musharakah for the particular consignment could be finalised through reference to the underlying agreement, and specifying the consignment and the proportion of equity participation. When a musharakah is finalised on a particular asset, the parties become co-owners of the asset, as a proportionate share in the ownership of the asset passes on to the newcomer, against proportionate share in the cost of the asset. As far as the financier becoming a joint owner in the asset is concerned, Hanafi, Maliki and Shafi’i jurists have considered the transfer of ownership here similar to that in tawliyah, i.e. sale at cost price, while Hanabilah describe it as the sale of a part of the asset. Thus, the establishment of joint ownership of the newcomer over the consignment represents the purchase of a proportionate share of the asset at cost price. Therefore, it is necessary that the initial owner of the asset have it in possession at the time of finalising the musharakah. When this procedure is adopted by Islamic banks for financing ready stock, the bank becomes a co-owner in the asset according to the proportion specified for equity participation, and the bank may thereafter disburse to the client a proportionate share of the cost incurred by the latter in acquiring the asset.

It is evident that through this procedure, the bank would become owner in only a part of the asset, as the initial owner retaining a proportion of the ownership is necessary for the formation of a valid musharakah relationship. Thus, financing for the complete cost of the asset does not appear feasible under this structure. However, it is understandable that even if the client retains a minimum share of the ownership, it is sufficient to create the musharakah. Such joint partnership may also prove convenient in later operations. For finalising the musharakah arrangement, ensuring possession of the bank’s share in an acceptable manner could be necessary as in the case of other purchases. After concluding the musharakah agreement thus, the client becomes empowered to dispose of the asset through sale etc. according to the nature of the venture, without the need for a separate agency. The mutual agency awarded by the musharakah agreement itself is sufficient for both parties to take part actively in disposing of the assets in a profitable manner. Thus, the bank may contribute its expertise in locating potential clients, marketing, advertising, providing financial management etc, as dictated by the nature of the asset. This could be of especial significance to MME clients, as the bank which could be expected to have superior access to market information, management and marketing skills, taking an active role the MME venture could provide a tremendous boost to the latter.

The client providing accurate information regarding the cost becomes important here, as the amount financed by the bank depends on the cost revealed by the client. If an amount exceeding the actual cost is given, the client may claim a higher amount of
profit than his due, if the profit sharing basis is the same as that of capital. Thus, when there is a doubt regarding the actual cost, the bank may become co-owner in the asset through purchasing the proportion wished to be owned at a price mutually fixed by the parties. Clear agreement of the proportion of capital contribution is necessary also for amicable division of any unexpected loss.

**Altering profit ratio due to delay in proceeds**

However, adopting this mechanism in this simple manner may not seem preferable to Islamic banks, in view of the prevailing practice of calculating the bank’s profit share on the basis of the capital outlay of the bank and the period taken for realisation of profits. The proportion of the bank’s profit share is thus calculated on the basis of the period taken for receipt of payment from the ultimate buyer. As often happens in the case of financing exports, the facility is approved only against a confirmed order supported by a letter of credit issued by the bank of the potential importer. Thus, the profit division ratio as a rule happens to be different from that of capital participation.

When the profit sharing ratio is arranged on this basis, if realisation of profits delays due to some reason, the bank may attempt to alter the ratio already finalised so as to compensate for such delay through an increase of its profit share. Despite of the clear formulae on profit and loss sharing agreed by the parties in such equity ventures, Islamic banks feel constrained at times to incorporate clauses that override them and permit the final distribution of profits to be on a footing other than what was agreed initially. To address some eventualities unwelcome to the bank, some musharakah agreements could involve a clause to the effect that the parties may alter the profit sharing ratio with mutual agreement. This could be achieved through means such as reserving the right to alter the profit sharing ratio after the inception of the contract, declaring that profits earned over and above a defined ceiling to accrue to one of the contractors unilaterally or that such profits would be relinquished by the other partner, and by agreeing on different profit sharing ratios for different strataums of profit earned through the venture. These provisions provide a level of flexibility in the division of profits, and are necessitated for purposes such as regulating the profits accruing to investment account holders and enabling the bank, where losses are not involved, to achieve a minimum level of return on its investments, or alternatively, to restrict its income to the due return on capital as dictated by the rate applied, while abandoning any additional profit gained above such return to the client. The latter measure is aimed at inducing clients to avail of Islamic banking facilities instead of resorting to interest based loans offered by conventional banks, by preventing the profit share of the bank from exceeding the interest charged by conventional banks for similar facilities.

Despite of the reasons that necessitate the employment of such provisions, the level of their Shari’ah admissibility could vary according to the nature of the particular
Financing Trade Asset Procurement and Disposal on Joint Equity Basis for MMEs...

provision. However, it is clear that such altering merely in view of the financial interests of one party seriously affects the consistency of equity relationships, which requires equitable sharing of vicissitudes. Regardless of permissibility, in addition to lowering the relationship to a level close to that of a lender-borrower, such alterations may lead to creating lack of faith in equity arrangements, as even frequent changes could be justified on this basis, thus paving the way to one party securing a fixed return. In the case of financing MMEs, the latter measure could prove singularly negative, as these results in the flexibility of the equity arrangement becoming limited to little more than a theoretical possibility. This could affect the primary reason which dictated employing equity modes in financing MMEs.

Additional costs incurred in disposal of assets

In the type of financing in question, the partners become co-owners in the stock to be traded. Thus, the initial capital is seen to consist of undivided shares in a jointly owned commodity, which, incidentally, is seen to fulfil the requirements of all schools Islamic law in this regard. However, it could happen that after the establishment of equity relationship through finalising the musharakah agreement, in the course of disposing of the asset, additional costs are incurred. These may be in the form of advertising, marketing, packing, carriage, shipping etc. Such additional expenses undertaken here by either party from his personal funds could raise two issues. The first pertains to the position of such expenses, whether they should be treated as infusion of additional capital or otherwise. If such later expenditure is considered as infusion of new capital, this may entail non-availability of part of the capital at the inception of the musharakah. The second issue is that if such expenses are undertaken by the partners disproportionately, when these as identified as additional capital, it may lead to disruption of the existent proportion of the partners’ ownership. If the capital contribution ratio itself is subject to fluctuation during the course of operations in this manner, finalising the musharakah agreement would need to be put off until all costs are known.

Contemporary scholars who approve of aggregating the total amounts disbursed towards the musharakah at the end of the tenure for calculating the total capital and verification of the proportion of ownership of the partners appear to have approved both of the above factors as valid. Thus, additional capital may be infused throughout the course of the venture, and ascertaining the total capital invested as well as the proportion of investment could be carried out at the termination of the venture. However, this position is hardly reconcilable with the accepted requirement that capital be existent at the inception of partnership or at commencement of operations, as emphasised in all schools of Islamic law. Although the manner in which the existence and availability of capital should be ascertained needs to be verified through an individual research taking the changes that have taken place in the nature and identity of money in the modern fiscal context too into consideration, it is
generally upheld by contemporary Islamic scholars that the capital should exist for the validity of musharakah. If infusion of fresh capital is needed, this may be achieved through a manner that does not expose the existent capital participation levels to fluctuation, which in essence is tantamount to initiating the joint venture afresh. As such, it appears preferable that the amount of capital involved in the venture and its proportion not be simply left uncertain until the end of the tenure, which could result in the anomaly of finalising the musharakah contract in a proper manner only at its liquidation.

Based on the above, in the equity arrangement in question, treating additional expenses undertaken by either partner in the disposal of assets as introduction of new capital does not appear justifiable. The preferable method to accommodate such expenses would be through the partners making available their proportionate share of the envisaged expenditure at the inception itself or prior to disposal of assets. This should not prove difficult, as in many such ventures, the costs necessary could be predicted with reasonable accuracy based on previous experience. Thus, along with undivided shares in assets, an additional amount of cash that could reasonably accommodate necessary expenses could be invested by each partner, which may remain in their possession. This may be upheld in view of the fact that monetary capital does not require mutual possession in the Hanafi School.xii

However, when the initial capital comprises of stock only and adequate monetary capital had not been made available for expenses, it is necessary to verify the position of costs undertaken by a partner in the course of the venture in this situation. Where a partner undertakes such costs with the approval of the other on behalf of the venture mutually owned by them, these could reasonably be treated as debts incurred by the venture for which the partners are jointly liable, and therefore have to be settled by both parties. If such debts are incurred for obtaining trade goods, they may involve a partnership on wujuh. In the equity mode discussed, the debts incurred towards expenses would merely represent liabilities undertaken by the venture that have to be settled jointly by the partners.xiii If such costs and expenses are in excess of the proceeds through the venture, the partners would need to settle them from their personal funds, as the liability of partners is unlimited. The mere fact that a partner had undertaken the expenses out of his personal funds, the venture thus becoming indebted to a partner instead of a third party, would not necessitate treating the instance as an infusion of fresh capital.

**Financing Procurement of Trade Goods**

Another instance where Islamic banks extend funds on equity participation basis pertains to obtaining stock for disposal. The client may seek for procuring stocks of a specific nature, that are required for meeting an order that has already been placed or for fulfilling a current demand in the market. Thus, financing sought here would
Financing Trade Asset Procurement and Disposal on Joint Equity Basis for MMES:

include the phase of procuring the asset as well as that of disposing of it and realising the proceeds. In financing MMEs, as in the case of financing other larger ventures, this category may embrace a vast variety of situations involving various means of procurement and disposal. Procuring assets could take place through import, purchase, manufacture, construction etc, and may even involve more than one of the above, such as when raw material or components are imported or purchased for processing or manufacture of the required item prior to disposal. Similarly, disposal of the assets may take diverse forms such as sale, export and lease. It is clear that due to the breadth of this category, it may overlap some areas involving long-term projects that were incorporated under the first category, i.e. financing venture capital. Therefore, in order to avoid this, the scope of this category can be restricted to financing procurement of specific assets that require minimum processing, for disposal in a ready market.

Debt based arrangements currently in vogue in Islamic banks for financing such enterprises may comprise of two different facilities granted separately towards each phase of the project. Thus, procuring the stock necessary may be carried out through a murabahah facility for its purchase or import, while disposal of the asset, as described above, could take the form of another murabahah arrangement for local sale or export based on the factoring mechanism, or even financed through an equity based facility. Consequently, the process may entail the bank earning a return in both the stages, usually based on the volume of the facilities as well as the durations taken for settlement in both instances. The nature of the second phase, both when financing is done through a debt based arrangement as well as where an equity basis is adopted, was discussed under the previous category, i.e. financing trade goods ready for disposal. We may briefly analyse debt based arrangements employed in financing the first phase, i.e. procuring stock, and thereafter discuss their equity based counterpart, which would embrace both phases.

**Debt-based structures for procuring stock**

The primary means employed by Islamic banks for facilitating procurement of stock is the mechanism known as murabahah, or more accurately, bay’ al-murabahah li al-amir bi al-shira (sale on murabahah to the commissioner to purchase). It is widely used in financing asset purchases of all types for consumption, utility or trading, in the local market or through import. Some perceived advantages in this format are entitlement of the bank to a fixed amount of profit based on its cash outlay and the period required for settlement, asset risk being limited to the minimum duration the asset lies in the constructive possession of the bank, resemblance in outcome to conventional banking facilities, and credit risk being covered by a pledge or mortgage. Several bodies of contemporary shariah scholars have ruled it permissible in facilitating asset purchase, subject to observance of the necessary conditions. The Islamic Fiqh Academy Jeddah has ruled murabahah sale to the commissioner to
purchase permissible on goods already in the physical possession of the seller as required by shariah, provided the seller carries the risk of loss before delivery, the consequences of returning the purchased goods because of concealed defects etc, and provided the conditions of the sale are met and with the absence of any impediments.\textsuperscript{15}

In murabahah financing as practised by Islamic banks, instead of extending a loan facility to the client for purchasing the required commodity himself, the Islamic bank purchases the commodity from the supplier first and after taking possession, sells it to the client usually on deferred payment basis, at a fixed price comprising the cost incurred by the bank and an additional margin of profit.\textsuperscript{16} Being limited to an appraisal of equity financing modes, this research does not purport to discuss or analyse issues pertaining to murabahah in detail. However, some vital aspects relevant to financing procurement of stock through local purchase and import on murabahah are surveyed below with minimum detail, to facilitate appreciation of the alternative equity based mechanism.

**Murabahah for import purchase**

Murabahah is popularly adopted by Islamic banks for financing imports, where the bank is expected to import the consignment in its name first and thereafter sell it to the client on murabahah. The procedure here is more complex as compared with murabahah for local trade due the involvement of Letters of Credit and import documents such as Bills of Lading and Airway Bills, as well as foreign exchange conversions.

After the overall agreement for providing murabahah facilities for imports is finalised, when a consignment is to be imported, the client submits the relevant Pro Forma Invoice acquired from the supplier to the bank, together with an undertaking to purchase the goods from the bank after the latter acquires them. Thereafter, the bank issues a Letter of Credit initiating the process of import. Upon receipt of the Letter of Credit through the negotiating bank, the supplier ships the goods and forwards the Bill of Lading, Invoice and other shipping documents to the L/C opening bank. The Bill of Lading and other documents are expected to be in the name of the L/C opening bank, which is held to indicate the bank’s ownership over the consignment. Upon receipt, the bank releases the shipping documents to the client by endorsing them in his favour to facilitate port clearance, at the same time effecting a sale transaction to the client through offer and acceptance. The goods are cleared by the client and taken possession thereafter.

**Aspects of concern in implementation of murabahah**

In financing procurement of trade goods on debt based formats, after the asset required is procured on murabahah from the local market or through import, if the
Financing Trade Asset Procurement and Disposal on Joint Equity Basis for MMES:

client so wishes, the disposal could be facilitated through a factoring mechanism adapted from murabahah, as mentioned above. However, this procedure is prone to error and abuse in both phases in many ways, which makes its proper implementation challenging. In employing murabahah in the first phase, due to the involvement of agency enabling the client to purchase the goods on behalf of the bank and take possession himself, the mechanism becomes vulnerable to abuse. Although such agency could be theoretically upheld as valid and may facilitate the bank’s purchase especially when it may not purchase directly from the supplier for some reason, due to this element, the distinction between the two ownerships, i.e. the initial ownership of bank and that of the client afterwards, becomes marginal, as the transfer from one to the other takes place while the goods are in the custody of the client. The agency also enables exploiting murabahah for obtaining funds, without the involvement of an asset. If funds are released to the client under agency even in a genuine transaction, the client could delay forwarding them, by negotiating credit terms with the supplier. The asset sought to be financed may have already been purchased by the client and taken possession before the involvement of the bank. Ensuring possession of the bank prior to selling the stock to the supplier presents difficulties. The client may even dispose of the goods before purchasing them from the bank, whereas doing so is lawful only after he purchases from the bank through the second contract.

Financing imports on the basis of murabahah presents additional complications. Ensuring the ownership of the bank over the consignment and bearing its risk prior to the sale to the client are matters of concern in this procedure. Since in a shariah perspective, there remains an amount of uncertainty over whether the shipping documents being in the name of the bank or to the order of the bank alone is enough to ensure complete ownership of the bank over the goods, the basis of murabahah in import transactions itself becomes vulnerable to an extent. Although consignment of shipping documents in the name of the bank is held to indicate its ownership a closer inspection of the related consequences reveals that, from a shariah angle, the entitlement of the bank here reflects features of an ownership of mortgage, i.e. a financial interest in the goods, more than those of a full-fledged ownership. This is because the risk relating to the corpus of the asset that necessarily accompanies ownership, is refused to be undertaken by conventional banks, in an instance such as when the asset is destroyed before endorsement in favour of the client. When the import is on D/A (documents against acceptance) terms where the supplier himself extends a credit period, ascertaining the cost incurred by the bank as required for the subsequent sale on murabahah becomes complicated. Here, since the payment to the supplier is to be remitted at a future point of time, possible fluctuation in exchange rates prevent knowledge of the exact cost incurred until payment. Thus, the murabahah needs to be converted into a musawamah in local currency.
**Equity structure**

It was mentioned that procurement of trade goods and their disposal, when bank involvement is sought for both, are financed through two distinct processes not necessarily related to each other, which are usually murabahah based. When such goods are known to be procured for meeting an order placed by another party or for fulfilling a specific demand in the market that is reasonably assured, employing an equity based structure could comprise both the above phases while significantly avoiding many of the vulnerable areas such as mentioned above. Instead of two facilities for each phase, the bank may enter into a musharakah with the client for procuring the asset needed and its disposal. The total capital outlay required for the project could be reasonably assessed, and the bank may invest a part of it as agreed with the client. After finalising the agreement, if purchase is to be carried out locally, the client may commence the process without the need for any agency from the bank, as the musharakah structure empowers him to undertake all activities necessary for the venture. Similarly, the bank too could discharge specialised duties necessary towards the venture, in the form of handling financial matters, processing documents, consultancy, providing storage etc. As indicated previously under financing asset disposal, such an active contribution towards the joint venture on the part of the bank would be especially helpful for MME clients, while providing the bank with a chance to better control and monitoring of the joint venture. If the goods are to be imported, the bank may undertake duties related to the import procedure, while the client may take charge of clearance, processing and preparation for local sale or export. The export procedure could again be handled by the bank on behalf of the partnership. The proceeds, when realised, would be divided between the bank and the client in the agreed proportion after reclaiming the capital and other costs. Any loss would be shared according to the ratio of capital participation.

Carrying out the second phase under an equity arrangement was discussed above. In the current structure, in addition to disposal of the assets through sale or export, the first phase consisting of procurement of assets too is brought under the equity arrangement. The major difference between the two structures is that, while in the former, the initial capital consisted of undivided shares in the available stock with the possible inclusion of an amount of cash, in the current structure, the initial capital would consist of cash only. This is because the stock needed is yet to be acquired. Thus, after determining the amount of capital necessary as well as the ratio of participation, the partners could make the capital available at the time of commencement of operations, through remittance of funds to the supplier or otherwise. It was shown above that the respective capitals could remain with the partners according to Hanafi jurists, as partnership only materialises in the assets procured for the venture and the profits realised. The profit sharing ratio, if decided to be other than that of capital participation, may be agreed, also taking into consideration the respective functions undertaken by the partners towards the
Thus, in the current banking practice, determination of the profit distribution ratio takes place based on the return the bank expects to realise through the venture, which is calculated based on the amount spent by the bank and the period taken for its recovery.

**Observations on the equity arrangement**

Due to transactional powers granted to a partner, many restrictions placed on him as the bank’s agent to purchase would be removed. Difficulties posed due to various stages involved in murabahah that should be strictly observed for its validity are absent under the equity structure. The different capacities borne by the client as an agent holding the goods in custody and thereafter as an owner, the need for timely exchange of offer and acceptance, restrictions on handling the asset until the purchase from the bank is finalised etc. are not found in the equity arrangement. Instead of bearing the risk and liability alone, throughout the tenure, the client shares the burden of any negative outcome with the bank in proportion to capital participation until the proceeds are realised. Presumably being the major partner in the venture injecting the larger share of capital, most of the risk would be borne by the bank.

In adopting the equity structure as a comprehensive scheme for MME financing embracing all stages from procurement of the asset until its disposal, many of the controversial aspects affecting the debt based arrangements are avoided. Issues such as the legal enforceability of the promise to purchase, credit price differing from the cash price, the possibility of imposing penalty due to delay in settlement etc do not arise under this arrangement. Since the item initially procured itself is to be disposed of, abuse of murabahah for obtaining funds for other purposes may not occur. Similarly, steps such as appointing the client as agent to purchase on behalf of the bank and the sale to the client on murabahah terms are not needed here, as the initial purchase of the asset from the supplier is for the joint venture, through which the proportionate ownership of the bank in the asset is established. Concerns related to import on murabahah too could be significantly eliminated through the equity structure. Acquiring sole ownership over the imported commodity in the name of the bank is not required in the equity structure, as it is purchased jointly by the bank and the client. Thus, uncertainty about the full-fledged ownership of the bank becomes irrelevant. Similarly, issues pertaining to ascertaining the precise cost are not applicable, due to the absence of a sale on murabahah terms.

As mentioned above under the equity structure for financing trade goods ready for disposal, if delays occur in receipt of payment from the ultimate buyer, this should not be a reason for altering the profit ratio originally fixed, as the partners are commonly affected. In order to avoid this, Islamic banks usually insist on sale against confirmed orders where payments are secure. The partners would be jointly responsible for supplying according to required specifications so that rejection or
return of the goods due to incompatibility with requirements could be minimised. However, in order to safeguard the interests of the bank in musharakahs involving the supply of specialised goods where the bank may lack adequate facilities for monitoring, the client could be made responsible for supplying according to specifications. If negligence of the client in this respect could be proved, he may be made responsible for any loss.\textsuperscript{xxi}

**Conclusion**

Equity based structures could be adopted with advantage for financing MME projects in a variety of situations. Being expressly designed for financing, these could replace in many instances debt based modes that have been tailored to fit in artificially. Equity based structures for procurement and disposal of assets, especially when used in an MME financing context, in addition to being distinctly advantageous through facilitating an equitable sharing of profit and loss, could significantly smoothen the process while avoiding negative aspects related to debt financing mechanisms. However, its application should be done in a way reflective of the reality of the equity partnership, which could lead to realising its full potential. Implementation of the equity relationship requires wholehearted participation by the bank in the operation of the venture in all possible means. In addition to financing ventures, the Islamic bank itself may play an active role in initiating diverse projects, and accumulate expertise and skill necessary for the purpose.

\textsuperscript{i} For an analysis of decreasing partnership and its practical application by Islamic banks in MME financing, see Muhammad Abdurrahman Sadique, “Financing micro and medium sized enterprises through decreasing partnership (musharakah mutanaqisah): refining Shari’ah and banking aspects for enhanced applicability,” in the conference papers of First International Islamic Conference on inclusive financial sector development organized by University Brunei Darussalam and Islamic Research and Training Institute in Brunei, 17 – 19 April, 2007.

\textsuperscript{ii} It should be noted here that if the goods are yet to be paid for, this fact alone would not adversely affect the ownership and title of the buyer in shariah. The buyer has complete title to the goods, which is unrelated to the debt devolving on him to the extent of the purchase price. Some schools allow that the goods themselves may be offered as security against the debt, through a separate contract.


\textsuperscript{v} Ali ibn Sulayman al-Mardawi, *al-In\textsuperscript{I}af*, Bayrut, Dar Ihya al-Turath al-‘Arabi, vol. 4, p. 438, Ibn Qudamah, *al-Mughni*, vol. 4, p. 95, Zayn ibn Ibrahim ibn Muhammad, Ibn Bakr,
Financing Trade Asset Procurement and Disposal on Joint Equity Basis for MMES:.. 141

al-Bahr al-Ra’iq, Bayrut, Dar al-Ma’rifah, vol. 1, p. 181, Sahnun ibn Sa’id, al-Mudawwanah al-Kubra, vol. 9, p. 80, Almad ibn ‘Ali ibn ×ajar al-‘Asqalani, Fat‘ al-Bari Sharf Ṭalil al-Bukhari, Bayrut, Dar al-Ma’rifah, 1379H, vol. 5, p. 136. Imam Malik requires that if the initial owner had purchased the asset on credit, the newcomer be required to submit his share of the cost based on identical credit terms. However, if the musharakah arrangement specifically refers to his payment of his share of the cost immediately, it is acceptable, as in this case it would be a sale on different terms.

For an analysis of how Islamic banks determine the profit sharing ratio, see Muhammad Abdurrahman Sadique, “Equity Partnership in joint enterprises by Islamic banks: Is a more equitable approach to sharing profit and loss possible?”, paper presented at International Accounting Conference IV (Intac IV), Putrajaya Marriot, Malaysia, 24, 25 June 2008.

The mention of such arrangements in the AAOIFI Sharia Standards and the questions posed to different Shari’ah boards indicate that such clauses are resorted to by Islamic banks. See e.g. AAOIFI, Sharia Standards 2002, 204, 205.

This aspect has been addressed by the author in his unpublished doctoral thesis A study of equity financing modes for Islamic financial institutions in a shari’ah perspective, International Islamic University Malaysia, Kuala Lumpur, 2007, chapter 4.


Contemplation on the essence of wujuh would reveal that it too comprises of liability forming the basis of the relationship.


See Islamic Fiqh Academy, resolution No. 40, 41, (2/5 & 3/5), 5th Session held in Kuwait in December 1988.


Muhammad Ahmad Siraj, al-Awraq al-Tijariyyah fi al-Shariah al-Islamiyyah, al-Qahirah, Dar al-Thaqafah, 1988, p. 36. The shariah boards of several banks have recognised the
bank’s endorsement of the documents to indicate a sale, which may indicate validity of the bank’s ownership according to them. See Faisal Islamic Bank Bahrain, *Fatawa of the Shariah Board*, pp. 22-23 (*Compendium*, p. 86), Kuwait Finance House, *al-Fatawa al-Shar’iyyah*, p. 278. AAOIFI Shari’a Standards considers the receipt of a bill of lading as constructive possession. (AAOIFI, *Shari’a Standards* May 2002, p. 119).

xviii According to conventional banking practice, “banks deal in documents, not goods.”

xix Al-Sarkhasi, *al-Mabsūʿ*, vol. 11, 152.

xx See ala al-Din al-Kasani, *Bada‘i‘ al-Ωanā‘i‘*, vol. 6, 100.