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Full Length Research Paper

Diminishing musharakah: Using a viable kind of equity financing instrument in managing the capital requirement of business

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This applied study was aimed at giving an insight to practitioners and academicians as well as investors and interested parties in understanding the characteristics and processes of an interesting shari'ah-compliant equity financing vehicle. Therefore, effort in identifying the related shari'ah concept and tenets as well as principles was closely studied in depth in order to justify on the validity of the instrument for the users of such financing facility. Related available documents were scrutinised in detail. A simple model of this form of vehicle was then proposed in this study. Thus, contributions in term of an innovation can offer a new knowledge to the practitioners as well as academicians and the interested parties of this financing instrument. Qualitative method of research and descriptive approach to research were applied in this study as they were appropriate in looking into the research issue understudied. Capitalising on the explored and examined instrument shall then become the basis in innovating more sophisticated models for multiplicity of instruments to be made available in the capital market both for domestic and foreign markets. In conclusion, this study contributed in term of an innovation initiative aimed at sustaining economic growth to up-hold the on going concern of enterprises during economic recession turbulence.

Key words: Shari'ah-compliant, equity financing vehicle, diminishing musharakah, musharakah investment model.

INTRODUCTION

This paper seeks to examine the operation of a diminishing musharakah investment model. Despites advances in both conventional and Islamic financial instruments, assurance on sustainability of businesses are crucial in financing their capital needs. Discovered writings suggest that financing vehicles and business management advisory roles are important in achieving sustainable growth, particularly during the time of economic recession. In response to the market concerns over the creation of quality products and services, this financing vehicle would be helpful to businesses. This innovation is not only trying to liberalise Islamic banking and financial institutions' roles but also to improve the nation's economic productivity and propagating a mechanism for distribution of the nation's wealth in a more realistic and equitable manner. In this study, the writer presented the mechanism of diminishing or decreasing musharakah as a way to ensure sustainability of businesses particularly, the small and medium enterprises in financing their capital needs.

Basically, Islamic mode of financing is based on profit and loss sharing and prohibition the charging of interest (Mohd Nasir and Amirul Hafiz, 2008). The profit and loss sharing is based on the shari'ah concept of musharakah. In designing a model of contract, one must observe the acceptability of the instrument, also on its ability in promoting productive activities. Therefore, in the process of designing musharakah investment model, a financial architect must consider four main characteristics or attributes in such product. Firstly, the basis must be rendered base on either musharakah concept. Secondly, it could accommodate for profit sharing and redemption under a profitable operation, which is term as musharakah mutanaqisah. Thirdly, the product should consider for appropriation to be made for operational losses and finally, the requirements for legal documentations.

Archival study

This paper was aimed to promote investment within the confinement of profit and loss sharing based on the concept of musharakah, which is a form of shari'ah-compliant equity financing. In an attempt to secure funding in the shari'ah recommended ways, it deals with securing property rights and social well being function (Masudul and Md, 2006). The writer believes that profit or loss sharing needs to cover a wider spectrum of business operation and not merely accounting for profit or loss. Of course, prior to extending any financing to potential entrepreneur, a financier still needs to adhere to prudent financing practices. This is the fundamental in order to ensure not to burden the entrepreneur at a later stage of the financing tenure. This could be done by proper and objective credit evaluation such as determining the need of financing by looking at the level of consumer demand of the potential entrepreneur. In addition to this, evaluation on the customers' confidence over the products and services provided has to be justified. Further, determine the growth of industry, products and services to justify any hurdles facing the industry. Finally, the aspect of substance over form needs to be analysed. This shall then be followed with providing the facility in the existence of probable outcome resulting by the materialisation of the financing. Another point to consider is whether there is any tax neutrality rule in the country as this concept of neutrality or parity could provide a conducive environment for the industry. In this respect, one has to consider the global market, local challenges and global opportunities.

Several studies and attempts have been done with the objective to implement financial models of Islamic vehicle of financing. Studies on partnership ending with ownership is about the idea of diminishing musharakah was first introduced as early in the 1970's. Qureshi, who was the then Chairman of the Muslim Businessmen Association of the United States of America, mooted it. The term diminishing (mutanakisah) refers to reducing or digressive in a capital joint-venture profit sharing contract (musharakah) that ultimately culminates in the ownership of asset or project by the entrepreneur. The theoretical framework that one should be concern with, in modelling this Islamic financial vehicle, is the shari'ah dictates. One is needed to properly observe the principles and tenets to ensure there is no element of violation whether directly or indirectly and thus, would validate on the usage of such innovated vehicle of financing. Generally, the shari'ah maxim for permanent musharakah is also applicable to the diminishing musharakah.

Next, the study discusses on the relationship between the provider of financing and the beneficiary party. The contract of musharakah is a partnership relationship or contract and not a creditor debtor relationship as in any debt financing. Thus, there must be a shared ownership, profits or losses during the tenor of the joint venture. It is a condition that the provider of financing must completely own its share in the joint venture as well as all the rights of ownership pertaining to the management of the venture. In the event, the financier party authorises the entrepreneur to manage the business, have the right of overseeing its supervision, and control as well as follow-up. It is not only improper but also not permissible to institute a recourse clause in any agreement of decreasing musharakah that adjudge the entrepreneur to refund to the financier party, the total of its share in capital in addition to profit accruing from the portion of its capital as this is resemblance to usury or riba. However, it is permissible for the financier party to offer a promise to sell its share in the capital to the entrepreneur party, provided the entrepreneur pays the value of the capital sharing. In this case the sale and purchase agreement must be concluded as a separate dealing without relating it to the contract of the joint venture.

METHODOLOGY

This study is the result of qualitative research using comparative and analytical methods (Sofyan, 2003). In modelling instrument based on musharakah concept, one needs to employ intelligence and creativity with analytical and scepticism mind. A simple model would normally lead to the understanding of the modus operandi of such instrument. It is worthy to work out the practicability in order to achieve the objective of this study. In modelling development of this instrument, the accountability model or framework was adapted from Gray et al. (1988, 1996). In designing this financial instrument, the writer considers taking into account of its robust characteristics which includes firstly, consideration on comprehensive public information on the overall business risk both initially and on continuous basis. As such, it is advisable that there is element of rating of the venture to be undertaken by all parties in the musharakah. Secondly, minimise risk by consideration on identified various fixed income opportunities. Therefore, future income streams have to be identified. Thirdly, conducting proper study, utilising scientific research methodology and thus, avoid adopting of short cut methods. This approach can determine the seriousness of efforts to implement diminishing musharakah financing. Fourthly, it must be seen as an instrument of monetary policy which should not be subject to heavy western influence, which aimed at enabling an economy to be stable with fair and just distribution of wealth between the deficit and the surplus units of the economy. Lastly, in absence of robust models, undue advantage can easily be taken by fund users under the musharakah schemes. A financier should consider the cost/benefit trade-off in investing in highly effective but potentially under-utilised methods (James and Carl, 2006).

DISCUSSION AND FINDINGS

In view of what have been identified in the earlier discussion, implementing diminishing musharakah instrument is another challenge. The writer is of the view that corrective measures need to be done to revamp the conservative system through exploration of opportunities in helping young entrepreneurs. By this approach substantial idle funds are invested in productive activities through this vehicle. A simple scenario to explain the rendering of the concept may be in the case of financing a two-storey shop-office premise of an entrepreneur by a financier which was initially concluded as a jointly acquired and owned property between the earlier and the later. Following with this deed, the financier then leases his share of the property to the entrepreneur on the basis of “Ijarah thumma al-bai'” (Mohd Nasir, 2001). Therefore, the entrepreneur is now an owner tenant, agreed to buy over periodically the financier's shares in the property by making rental payments to the financier under the “Ijarah” deed. Such rental payment will of course be partially contributed towards increasing the entrepreneur's share in the property.

The choice between innovation and adaptation when it comes to offering Islamic financial products, perhaps finding a middle ground is the best approach (Kamal, 2009). In designing a simple model of diminishing musharakah financing vehicle, with an assumptions that, a financier owns 90% and an entrepreneur owns 10% of a jointly owned property. Under the Ijarah deed, the entrepreneur's monthly rental payment is RM1, 000. Under the diminishing musharakah deed, each rental payment made and received is shared based on the earlier capital-sharing ratio of 90:10 or any pre-agreed profit sharing ratio. As such, RM900 is applied as reduction to the financier's equity participation whilst at the same time increasing the entrepreneurs share in the property and further, RM100 is applied as an increased to the entrepreneur's share in the property. However, the “Ijarah deed” allows the financier and the entrepreneur to come to an agreement on the quantum of the rental be applied in decreasing the financier's share in the property whilst at the same time increasing the entrepreneur's share in the property for the same amount after recognising a portion of it as profit from the lease income. In practising this, of the RM900 apportioned as the right to the rental received by the financier, the financier may recognised RM750 as profit and the remaining RM150 be applied as reduction in equity sharing in the property for the first month of the rental received during the rental tenancy of the entrepreneur.

Conceptually, parties to the contract of diminishing musharakah in a project will have to study the viability of the project at the earlier stage based on income forecast and thus, be prudent and tactful in making decision in the venture. The partners of the capital joint venture, which stipulates the capital sharing, the share of the profits and description of project shall then conclude these by way of executing of diminishing musharakah agreement. In this agreement, provision pertaining to the manner in which the financier party's capital sharing in the property be diminished in favour of the other party, the entrepreneur be provided. It must also stipulate that the remaining be kept by the financier's party. Therefore, in this way, the financier's share of the equity is progressively reduced and the other partner, the entrepreneur, will eventually become the sole owner to the project or property.

When a financier party is entering into a diminishing musharakah, the intention is not to stay in the partnership as an ongoing concern but only for the specific tenor in the contract. The financier party may either accept payment/s on lump sum or instalments basis and such amount must be justified for the exchange the financier's partnership interest. Therefore, in this way the financier party receives payments over and above, his share in partnership profits and such partnership interest reduces until it is completely bought over by the entrepreneur party. Finally, after the discharge, the financier withdraws its claim from the entrepreneur and the entrepreneur solely owns the project or property. The ongoing concern over the project or business is then lies on the part of the entrepreneur. This product is actually an innovation, which differs to permanent musharakah as it concerns with the joint ongoing concern. It appears that the diminishing partnership can be understood as participation in the capital and profit and loss joint venture. The intent of the project is capital growth. The distribution of wealth is accrued from the project. The financier sells his share of capital. This process continues until the financier has fully compensated for its capital share of the joint venture and the financier has his principal or amount provided as financing plus profit earned during the tenor of the joint venture.

The diminishing musharakah mode of financing is suitable for the financing of manufacturing, trading as well as service businesses that have regular income. It is considered appropriate as the financier earns periodic profits throughout the tenor of financing and at the same time it encourages the entrepreneurs to participate directly and actively in undertaking economic activities and thus, boosting the nation's productivity. The point of prime important to be noted is that, such vehicle can foster individual ownership by allowing the entrepreneurs to gradually buy the financier's ownership interest in the joint venture.

Next, in term of society as a whole, it corrects the imbalance of wealth distribution of an economy through expansion of this spectrum of positive partnership that may overcome the phenomenon of indebted entrepreneurs. Therefore, it is capable of assisting in the equitable distribution of society's wealth. In order to understand the application of diminishing musharakah mechanism in shari'ah-compliant banking business further, let us learn on a type of banking facility - for instance home equity, using this principle in it operation. Normally, such facility is approved with specific terms and conditions. The purpose of this facility is normally to part finance the purchase of house or property inclusive of financing of mortgage coverage and other incidental amounts financed by a bank.

In discussing the method of financing under this financing vehicle, the financier and the customer jointly purchase the rights, interests and benefits in an identified property. The customer then, contributes a sum equivalent to the initial acquisition payment, which is usually referred to as customer's initial acquisition payment. Subsequently, the financier contributes towards the purchase of the property a sum equivalent to the financier's commitment amount, which is usually referred to as financier's commitment amount. The customer then, gradually acquire the financier's ownership interests, rights and benefits in the property by making monthly payments in accordance with the terms of the facility until the customer wholly and fully own the property. The monthly payments made under the facility resulted in the increased of customer's ownership interests in the property. On the other hand, the financier's ownership decreases proportionately. Such increase and decrease could happen within a stated tenure of the financing.

Mathematical modelling along with explanation method was used in this study in describing the diminishing musharakah equity financing model. Such approach was adopted from the theoretical exploration study by Masudul (2008). In determination of the pricing, assume the margin of profit is 1.5% per annum. It is then stipulated as 1.5% per annum on monthly rest, for 12 months to be effective from the date of first release of the financing amount. The payment of financing in this discussion is by monthly payment based on agreed tiered margin of profit, until full settlement of financing. The mode of payment is usually by way of variable standing instruction to meet client's monthly instalment payments and amount due to his financing account. The collaterals or securities include musharakah mutanaqisah co-ownership agreement, the first legal charge over the property and deed of assignment over the property. By deed of assignment of the sale and purchase agreement with power of attorney to transfer or otherwise dealt with the property, pending issuance of the individual title or strata title. Such deed of assignment shall then be replace by first legal charge when individual or strata title is issued. In any case, the power of attorney clause need not be incorporated in the assignment, a blank memorandum of charge or charge-in-escrow shall be executed.

The financier has the right of entry or re- entry for the purpose of inspection of the property. It also has the right to cure any defects affecting the property but shall not at any time impose any obligation upon the financier to cure or rectify such defects. In addition, the financier posses the right to receive notice and at its discretion, give or refuse consent to any further creation of security interests over the property except for the creation of security interests to secure the monthly payments under the facility. The financier also has the right to approve any significant improvements to the property, but such right shall not impose any obligation upon the bank to make or pay for such improvement and the right to approve creation of any lease for a period of more than three years. On the contrary, the customer's right in relation to the property under the financing include the sole and exclusive right to occupy, use and quiet enjoyment of the property.

Conclusion

The discussion of this study is not complete without the descriptive on the financing administrative standard procedural instructions. In normal practice, the facility is disbursed progressively or in one lump sum payment. Provision on compensation charges (ta'widh) in practice is probable to avoid element of procrastination in its dealing. An entrepreneur who is a partner to the financier party is liable to pay "ta'widh" on the amount overdue and payable to the financier. It is calculated in the manner as approved by the regulator or any other appropriate authority for overdue instalments and for matured financing. The central credit unit or central credit bureau is to collect information from financiers regarding the credit facilities granted to their customers. This is to enable participating banks to be informed by the unit of the aggregate financing granted to the customer by other banks. The information is strictly confidential between central credit unit and the participating banks.

Therefore, it is a term of a facility that information regarding it shall be given to and use by the bureau and the participating banks. In concluding this discussion, it is therefore, in order to substantiate the modus operandi of this instrument, diminishing musharakah its co-ownership agreement and security documentation, in the form and substance, incorporating, among others, the terms and conditions must be executed timely. This is to ensure the efficient and effective dealing of such instrument and remain competitive to substantiate this asset or investment facility.

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