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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 [Mohd Nasir, 2009]. 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, and 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 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 was presented.

Basically, Islamic mode of financing is based on profit and loss sharing and prohibiting the charges of interest [Mohd Nasir and Amirul Hafiz, 2008]. The profit and loss sharing is based on the "shari'ah" concept of "musharakah". "Musharakah" refers to contract of capital joint-venture profit and loss sharing. In designing a model of contract, the acceptability of the instrument is observed, 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, if it can accommodate profit sharing and redemption under a profitable operation, which is term as "musharakah mutanaqisah". Thirdly, the product is considered 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 Mostaque, 2006). Based on this research, it is believed 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 avoid the possibility of burdening 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 determination on the growth of the industry, products and services is carried out to justify any hurdles facing the industry. Finally, the aspect of substance over form needs to be analysed. This is then followed by providing the facility in the existence of a probable outcome resulting from 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, it is advisable to consider the global market, local challenges and global opportunities.

Studies on partnership ending with ownership is about the idea of diminishing "musharakah". The term diminishing "mutanaqisah" 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 frameworks that should be concerned with, in modelling this Islamic financial vehicle, is the "shari'ah" dictates based on "Qur'an and sunah". There is need 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, discussion on the relationship between the provider of finance and the beneficiary party is made. 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, the financier party shall 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 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). Comparison on the *modus operandi* of this instrument was carried out against the underlying "shari'ah" concept and principle in use. Analytical method was use to ensure and validate its "shari'ah-compliance". In modelling instrument based on "musharakah" concept, there is 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.

DISCUSSION AND FINDINGS

In designing this financial instrument, this research takes into account its robust characteristics based on observation from experiences of field study which include; firstly, by considering comprehensive public information on the overall business risk both initially and on a 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, by minimise risk, by consideration on identified various fixed income opportunities. Therefore, future income streams have to be identified. Thirdly, conducting proper study by utilising scientific research methodology and thus avoiding the adoption of short cut methods. This approach can be used to 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 et al., 2006).

In view of what have been identified in earlier discussion, implementing diminishing "musharakah" instrument is another challenge. This research is of the view that corrective measures need to be done to revamp the conservative system through exploration of opportunities in helping new 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 is initially concluded as 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, 2001a,b,c]. 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 a 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 been 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 practice, of the RM900 apportioned as the right to the rental received by the financier, the financier may recognise RM750 as profit and the remaining RM150 been 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 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 of the property is being diminished in favour of the other party, is provided to the entrepreneur. 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 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 in the exchange of 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 then lies on the part of the entrepreneur. This product is actually an innovation, which differs to permanent "musharakah" as it is concerned 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 its share of capital. This process continues until the financier has fully compensated for its capital share of the joint venture and the financier has its 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 in 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, let us further learn 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 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 studied 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 is then replaced 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 is 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 does 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 does 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 ex-clusive right to occupy, use and have a quiet enjoyment of the property.

Conclusion

The discussion of this study is not complete without the discussion 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 it is paid 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 in terms of a facility that information regarding this is given to and use by the bureau and the participating banks. In conclusion, 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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