

SHARĪ‘AH POSITION ON ENSURING PRESENCE OF CAPITAL IN JOINT EQUITY BASED FINANCING

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Islamic legal texts indicate that a joint venture involving monetary capital could be set in motion on the basis of capital that is existent and present, with clear agreement regarding the share of each partner. While gradual release of capital is admissible, prior existence of capital is necessary. Due to credit supplementing real money in a substantial manner, the identity of money in the current fiscal environment appears to have undergone significant change, the nature and influence of which need reassessment. This is crucial for determining the form in which the existence and presence of capital could be ensured. The emphasis placed in Sharī‘ah on existence and presence of capital could indicate a measure for thwarting unwelcome monetary expansion, thus controlling inflation.

1. INTRODUCTION

In the context of equity financing involving Islamic financial institutions, an area of concern with regard to the nature of capital pertains to ascertaining the existence of capital at commencement of joint ventures. This paper analyses the issue from a *Sharī‘ah* perspective, albeit restricted to aspects relevant to the practice of Islamic banking. The nature of partnership capital with regard to its existence and presence as reflected in Islamic legal texts is explored, together with its implications in the modern context. The current practice of Islamic banks in this regard is scrutinised thereafter, together with an assessment of the contemporary *Sharī‘ah* approaches to the issue. The paper then goes on to consider the changes that have taken place in the nature

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and essence of money and monetary value today, and examines whether this aspect should have a bearing on the subject.

2. EXISTENCE OF CAPITAL AT THE INCEPTION OF MODERN PARTNERSHIPS

Equity enterprises in the modern context are not always established on the basis of monetary capital that is existent and present (*'ayn ḥadir, la dayn*) at the inception as stipulated in Islamic legal texts. In conventional law, in the case of a partnership, there are generally no fixed rules regarding contributions to capital or its maintenance. Under the partnership agreement a partner may be required to inject further funding from time to time; it could be credited to its capital account, if stated, or in effect be regarded as a loan.¹ Partnerships could be formed on the basis of capital yet to be paid, and may come into being while the whole capital or part of it remains in the form of debt. While capital requirements for the formation of companies are relatively stricter, existence or presence of capital as emphasised in Islamic law is not seen to be required. As long as the agreement is valid and the legal requirements fulfilled, the existence or the nature of capital at the finalization of the contract is not of material relevance in conventional law.

3. RELEVANCE OF EXISTENCE OF CAPITAL IN THE CONTEXT OF ISLAMIC BANKING

With regard to Islamic financial institutions, the issue of existence of capital becomes relevant in many situations. However, when the scope is narrowed to a specific treatment of Islamic banking operations, the issue in question appears to be of especial relevance in the case of temporary equity relationships created by the bank with its clients on *mushārah* or *muḍārah* basis, for purposes such as financing of single transactions and project financing. At times it could even be an admixture of these two modes, where the outcome would essentially reflect aspects of both *mushārah* and *muḍārah*.²

In such temporary partnerships created for the purpose of financing, the equity stake of the financial institution in the project is fixed at the inception.³ In the case of financing single transactions such as the procurement of a single consignment of goods and their sale or a single import or export, the capital input required could

¹ Hewitt, 2001 p.189.

² Obaidullah, 2005, p. 61; Taqi Usmani, 2000, p. 57.

³ Bank Islam Malaysia Berhad, 1994, p37.

even be released in full at the inception itself.⁴ However, if the relationship involves a relatively longer-term commitment such as project financing, more than not, release of the funds *in toto* does not materialise at the outset, which occurs gradually as the venture moves forward. Thus, only an agreement to contribute made by the financial institution in the future is existent at the of the equity venture, as borne out by the basic partnership agreement. the working partner, i.e. the client, initiates operations, usually through his share of the capital. The subsequent release of funds by the bank could take place on an agreed future date, or a specific schedule could be drawn for the release of capital in stages. A common procedure adopted by Islamic banks, especially in the financing of projects where funds are required over a period and the availability of the whole capital share at one time is not essential, is to open a running account in the name of the venture. Here the bank's participation materially occurs in amounts and times decided by the working partner in the future. In both of the above contexts, the question appears pertinent whether the capital could be considered to have been existent and available at the commencement of partnership.⁵

4. SHARĪ'AH PERSPECTIVE OF EXISTENCE AND PRESENCE OF CAPITAL

The *Shari'ah* perspective of capital in the above methods of equity financing could differ based on the Islamic mode employed. With regard to the types of financing referred to above, these appear to be based on *musharakah* more often, either partially or in totality, as a portion of the investment invariably comes from the working partner. Schools of Islamic law agree on the fundamental issue that, for the validity of all capital-based partnerships as well as *muḍārabah*, the capital should necessarily be existent and available, although there is difference of opinion regarding the details concerned. Therefore, a debt does not qualify as capital, nor does wealth that is absent or is not under the control of the partners.⁶ However, as

⁴ Although this is possible, a configuration based on *musharakah* is more practicable. See for details Abdurrahman Sadique, 2006, unpublished doctoral thesis.

⁵ It should be noted that what is analysed here is a single joint partnership venture initiated through finalising a contract of partnership between the bank and the client which is customarily referred to as a *musharakah* / *muḍārabah* agreement, and not a mere overall agreement to enter into a series of *musharakah* / *muḍārabah* based transactions in the future. In the latter case, as a specific partnership venture does not originate at the formation of the preceding overall agreement, the existence of capital at that point of time is irrelevant.

⁶ Debt does not qualify as capital in *musharakah* or *muḍārabah* in the case when it is owed by one partner in *musharakah* to the other, or by the *mudārib* in the *muḍārabah* to the

explained below, surrendering the capital input of each partner to the other is not deemed mandatory, especially in the Hanafi school.⁷ A partner is allowed to transact in the capital contributed by the other partners based on the agency granted through the contract of *musharakah*, as partnership essentially implies the right of all the partners to contribute effort and take part in the management of funds. In this respect, the concept of *musharakah* displays a fundamental divergence from that of *muḍārabah*.

It is pertinent to examine the position of Islamic schools of law on the issue. With regard to the existence and presence of the capital at the inception of the contract, the Shāfi'i school is noted for the stress it places on this aspect, more than others. Shāfi'i jurists deem co-ownership of all the capital a prerequisite for the formation of a valid *sharikat al-'aqd* (joint venture). The presence of jointly-owned capital is also imperative for *shirkah al-māl*, i.e. capital-based partnerships. This factor is of such importance that capital which is physically separate and is in the possession of individual partners is not considered sufficient for initiating *musharakah*. Only jointly-owned property is acceptable, where the partners share in the ownership of every unit of the capital, or at least, individual units belonging to each partner are not distinguishable from that of others, for the sake of ensuring joint liability in a factual manner.⁸ This follows the position maintained by Shāfi'i jurists that units of monetary currency are distinct entities, where particularization (*ta'yīn*) is possible. Therefore, this condition necessitates the existence and presence of the capital in a precise manner at the inception itself for commencing a *musharakah*, in the Shāfi'i school.

The position of the Hanbali school appears similar to the Shāfi'is in this respect. The Hanbali school, too, does not allow the formation of *sharikah* when the capital is absent, as it hinders immediate commencement of operations. According to Ibn Qudāmah, it is not permitted that the capital be comprised of funds that are absent or a debt, since initiating transactions (*tasarruf*) at once, which is the objective of *sharikah*, is not possible.⁹ Thus, in the view of the Hanbali school the contract of *sharikah* should be capable of being executed instantaneously, and absence of capital that hinders this function is impermissible.

capital provider. See references in the discussion below, and Ibn Qudāmah, 1992, vol. 5, pp. 127, 190 and 191; al-Kāsānī, 2000 vol. 6, p. 96; Al-Māwardī, 1999, vol. 6, p. 482 and vol. 7, p. 309; Ibn Rushd, 1969, vol. 2, p. 257. One reason for this ruling is the incidence of profit to the creditor in return for postponement of the debt.

⁷ For a detailed discussion on the theory of partnership in each school of Islamic law and how it regards capital, see Sadique, 2009.

⁸ See discussion on Shāfi'i perception of *sharikah* and illiquid capital below, and al-Ramlī, n.d., vol. 5, p. 7.

⁹ Ibn Qudāmah, 1992, vol. 5, p. 127.

The Māliki school differs somewhat from the above position in that it appears to recognise the possibility of forming a valid *mushārah* contract even when the capital of one partner happens to be absent, provided it is located at a short distance as defined by them. However, it is imperative that the capital is available at the commencement of operations.¹⁰ Therefore, a debt may not become capital in partnership. Presence (*ḥuḍur*) of the absent capital indicates taking possession of it. Until the absent capital is made available, the capital that is present should not be involved in transactions.¹¹ Māliki jurists have thus overlooked the occurrence of a slight delay in the implementation of the *sharikah* for acquiring capital located elsewhere. This indicates the existence of capital at inception is mandatory even though presence is not. However, if a partnership is initiated when a part of the capital is not available, and transactions are started with the available capital due to the partner concerned failing to procure the absent capital, Imām Mālik apparently holds the partnership valid in this instance. The profit is distributed according to the ratio of the capital that was available, and not according to the capital ratio as envisaged in the beginning.¹² This means that the capital becomes limited to the amount that was available.¹³

The Ḥanafī school, while insisting on the existence and presence of the capital for the validity of *musharakah*, has adopted a different stance. The capital should be existent (*ʿayn*) and present (*ḥāḍir*), and may not be a debt or absent property.¹⁴ However, although Ḥanafī jurists stress on the presence of capital for the legitimacy of *mushārah*, they have not insisted that it be available at the time of contracting itself. On the contrary, presence of capital at the commencement of operations has been considered sufficient for the fulfilment of this requirement. Presence at the formation of the partnership contract is not stipulated, as the latter is valid even if the capital is not existent at the time of contract.¹⁵ Although another position maintained by some Ḥanafī jurists indicates the invalidity of partnership when the capital is not submitted at the inception and that the partnership is formed anew when the capital is made available later, Ibn ʿĀbidīn gives preference to the first. The same is reiterated by al-Kāsānī.¹⁶ Al-Sarkhasi too stresses that the partners producing the capitals specifically distinguishing it (*taʿyīn* - particularisation) at the time of contracting or transacting is a condition for

¹⁰ Al-Khurashi, 1997, vol. 6, p. 342.

¹¹ al-Dardīr, (n.d), vol. 3, p. 350.

¹² Saḥnūn ibn Saʿīd, (n.d), vol. 12, p. 62.

¹³ A similar position is adopted by Shāfiʿi jurists when part of the capital is withdrawn before commencing operations. See al-Sharbīnī, 1998, vol. 2, p. 432.

¹⁴ Al-Kāsānī, 2000, vol. 6, p. 96.

¹⁵ Ibn ʿĀbidīn, 1979, vol. 4, p. 311.

¹⁶ Al-Kāsānī, 2000, vol. 6, p. 96.

the validity of partnership.¹⁷ This situation is illustrated by a partnership between two individuals, one of whom hands over his portion of the capital to the other with the demand that the latter contribute an equal amount and purchase against the whole, the profit being divided among them. Both Ibn ʿĀbidīn and al-Kāsānī assert that if the latter could prove that this was duly carried out, the partnership stands valid, in spite of the absence of the capital of one partner at the inception.

It is evident from the above that the existence and presence of capital at the commencement of operations is unanimously required in all schools. As far as the relevance of capital to the formation of partnership is concerned, while the majority of schools hold the existence of capital mandatory at the inception itself, the Hanafi school does not require the capital being existent and available at this stage. In the established opinion of Shāfiʿi and Hanbali schools, both the existence of the capital and its presence at the inception of partnership are mandatory. The Māliki position as described by al-Khurashi indicates that although the non-availability of capital could be condoned at the inception of *sharikah*, nonetheless, capital should be existent at this point, even though located away from the partners. The legal positions could be summarised as in Table 1 below.

Table - 1
Existence and presence of capital at inception of venture and commencing operations according to schools of Islamic law

School	Nature of capital at inception of partnership		Nature of capital at commencement of operations	
	Existence	Presence	Existence	Presence
Hanafi	Not necessary	Not necessary	Necessary	Necessary
Māliki	Necessary	Not necessary	Necessary	Necessary
Shāfiʿi	Necessary	Necessary	Necessary	Necessary
Hanbali	Necessary	Necessary	Necessary	Necessary

The Hanafi school, in what could be regarded as an extension of their stand of considering presence of capital sufficient at the commencement of operations, argues that a partnership could come into existence even if the partners invest their respective capitals separately, without pooling the capitals together. Hanafi jurists hold that the essence of partnership is realised even through the partners' common sharing of profits, and profess that it does not necessarily require jointly-owned capital. Accordingly, it appears that after the formation of partnership, if each partner invests and operates his capital on his own without combining the capitals

¹⁷ Al-Sarkhasi, 1406H, vol. 11, p. 152.

or managing them together, it is not against the fundamentals of partnership in Ḥanafī school. Thus, the partners may share in the profits jointly even where investment is carried out individually.¹⁸ The partners share loss that affects capital only if the capitals had been combined.¹⁹ Otherwise, loss that befalls the capital of a partner before it is invested in the operations is borne by the respective partner solely. Nevertheless, a loss at this stage would result in the voidance of the partnership, as the basis of the contract is no longer existent.²⁰ The partners are free to enter into a fresh contract based on fresh capital. Ḥanafī jurists have suggested a mechanism if the partners wish to share the liability of any loss that befalls the capital of one of them even before the commencement of operations. It is that the partners should contract the partnership after having established a *sharikat al-milk* (i.e. joint-ownership) in the capitals, by a mutual sale of a part of one against a part of the other. In this event, the partners will be jointly responsible for any loss right from the inception of partnership.²¹

5. SHOULD THE WHOLE CAPITAL BE MADE AVAILABLE?

It was shown above that the commencement of operations by either partner marks the finalisation of the *mushārah* contract in Islamic law. Is it necessary that the whole capital be made available by all the partners at this point, although only a part of it is engaged in transactions immediately, and the investment of the rest scheduled to take place later in stages? It was seen from the texts referred to above that all the schools of Islamic law insist on the availability or presence of the capital at the start of operations. Although difference exists on whether this is necessary at the inception of the *mushārah*, as far as commencing operations is concerned, the schools, including Ḥanafī jurists, appear to be in agreement about the fact that the capital should necessarily be available at this point. The Ḥanafī school, in spite of allowing the commencement of transactions by one of the partners initially, stipulates the general requirement that the partners make their capital available, even though it could remain in their own possession until

¹⁸ It should be pointed out that this stand appears wholly in keeping with the position maintained by Ḥanafī jurists in recognising *shirkat al-wujūh* and *shirkat al-abdān*, where the partners are observed to share in the profits, although each partner might not have been necessarily involved in the specific labour that resulted in the profit. Common capital is definitely not the basis for division of profits here due to the total absence of the capital element, which is the basic reason for the Shāfi'ī rejection of these two modes.

¹⁹ See for details al-Kāsānī, 2000, vol. 6, p. 97, Ibn al-Humām, (n.d), vol. 6, 179. The Māliki position is similar to some extent, who say that if loss occurs in the capital of one partner after both capitals are combined or deposited with one of the partners, it is considered as a loss of the partnership. Saḥnūn ibn Sa'īd, (n.d), vol. 12, p. 66.

²⁰ For further details on how loss of capital affects partnership, see the author's forthcoming work, *Capital and profit-sharing in Islamic equity financing*.

²¹ Nizām et al., 1406H, vol. 6, p. 405. For further details see Sadique, 2009, Part 2.

investment. The Shāfi‘i and Ḥanbali schools require the presence of capital even before.

What is evident from Islamic legal texts is that the capital in total as agreed for the project should be available at this stage, although investment physically could take place later according to the demands of the venture. The Shāfi‘i school has gone to the extent of insisting on combining the capitals thus forming a single pool under joint liability, distinguishing it as the asset base of the partnership. The Hanafi school, too, apparently making an exception to the general position maintained by them that monetary currency is not distinguishable, asserts that capital comprised of money, when specifically identified as the capital base of the partnership, becomes specific and distinct (*muta‘ayyin*) as in *waṣīyyah* and *hibah*. If such specific capital meets with loss before the start of operations, the partnership is annulled. This is because of the fact that the capital is considered the subject matter (*ma‘qūd ‘alayh*) of partnership. With the loss of the subject matter, the contract becomes void.²² When the capital is comprised of *mithliyyāt*, i.e., generic commodities, mixing as required by the Hanafi and other schools ensures their identification. If *mutaqawwim* goods, i.e. commodities other than *mithliyyāt*, form the capital, these require mutual sale, in which process identification is inevitable. However, in keeping with their original position, Hanafi jurists hold that at the time of investment and trading, payments could be made even through funds other than the money set aside as capital because of the fact that currency is not distinguishable.²³

Therefore, formation of a valid partnership can be held to take place on the basis of a known amount of capital that is existent and is available in an acceptable manner, with the proportion of participation clearly determined. Leaving the capital unspecified at the inception and allowing it to fluctuate, or postponing the procurement of capital until the need for disbursement arises, does not appear to be in keeping with the above requirement. The capital, once made available at the outset, could be released gradually according to the operational needs of the venture. Until demanded for active involvement, it could be engaged in temporary investments in permissible ways, the proceeds of which should necessarily accrue to the partnership as a whole.

6. IMPLICATIONS IN THE MODERN CONTEXT

²² See Al-Marghīnānī, (n.d), and its commentary Ibn al-Humām, (nd), vol. 6, p. 179. Some consider the subject matter of *sharikah* to be capital and labour both. While the existence of capital is mandatory, existence of labour carries details. (Ibn Taymiyyah, (n.d), vol. 30, p.148)

²³ Ibn al-Humām, (n.d), vol. 6, p. 182.

The above bears out that with regard to monetary capital, the schools of Islamic law prescribe availability of the capital earmarked for the venture in cash, which would form the basis of partnership. This seems to be required in addition to having the necessary amount of capital in the possession of the partners at the time of starting operations. Obviously, a mere acknowledgement to contribute a specific amount of capital in the future without having it available in cash is insufficient to fulfil this requirement. Therefore it is evident that the purport of the ruling is the presence of the capital in liquid form. If the partnership is to be formed on the basis of capital other than cash, this has to be specifically agreed and a suitable form of partnership such as partnership on commodities (*'urūd*) adopted.²⁴

However, fulfilling this condition in the contemporary commercial environment could be complex. Partnerships are not always created with the entire capital in hand. Sometimes, the sheer magnitude of the venture would make ensuring the presence of capital impracticable. In the context of the current financial culture, having liquid cash in possession, especially in large amounts, is not common. Monetary value is usually held in a variety of forms including real estate, bank deposits, shares, etc. in addition to cash. Even if assets such as real estate are excluded from available property, the position of other forms of wealth requires consideration.

In the context of *mushārah* relationships created by Islamic banks, the application of this condition would require that the Islamic bank as well as the working partner set aside the capital amounts they have agreed to invest in the project at the point of starting operations. While the initial investment by either party would usually form only a part of the total capital allocated, the total amount should be set aside at this juncture. After the partnership has set off in the prescribed manner through the commencement of operations with the necessary capital stock as its base, there could be no objection to converting the capital into debts and other assets as required in the course of managing the partnership. Therefore, the capital could be converted into a bank deposit in the name of the venture, either with the Islamic bank itself or with another entity. Alternatively, the partners could retain the capital separately, by depositing in separate accounts or otherwise, and release gradually according to the needs of the business.

²⁴ Contracting a partnership based on capital in the form of illiquid assets, i.e. capital contributed in kind rather than cash, is a topic that has been thoroughly analysed in Islamic legal texts, that amply highlight the coherence of rulings and the highly methodological approach adopted in deriving them. While some jurists, principally of the Maliki as well as of the Hanbali schools, hold that a partnership may be established on the basis of illiquid capital directly, others require prior establishment of joint-ownership. The discussion on the issue is directly related to the fundamental perception regarding the essence of partnership in schools of Islamic law. See for details Sadique, 2009, Part 2, and his *Capital and profit-sharing in Islamic equity financing*, forthcoming.

On this basis, for practicability in the case of larger ventures where making the whole capital available at the outset is not feasible, the project may need to be broken into several *sharikahs* that may follow one another. The immediate capital may be limited to the amount that is currently available, and the partnership initiated on that basis. Thereafter, additional capital infusion can be done by employing a process such as constructive liquidation ascertaining the current value of the assets, and starting a fresh *musharakah* based on the total amount of capital, after injecting additional funds. In doing so, the existent proportion of investment could be maintained, or an altered ratio adopted, as seen necessary.

7. ANALYSIS OF THE PRACTICE OF ISLAMIC BANKS ON THE ISSUE

Having laid down the position of the schools of Islamic law on the issue, we could now examine the routine modus operandi as found in the practice of Islamic banks in this regard. As outlined earlier, in financing relatively longer-term *musharakahs*, in the simpler form, the bank would release the allocated capital in portions. The other method employed is to open an account in the name of the partnership, allowing the working partner to make drawings as and when necessary.

Stated briefly, in the first process, at the start of operations through conducting an initial transaction on behalf of the *musharakah*, which is usually done by the client through his own capital or through an initial release of funds by the bank, the status of the rest of the capital remains uncertain. The unreleased capital is only represented by the obligation on the bank created by the *musharakah* agreement to release funds in the future and the limit allocated for the venture in the accounts of the bank. Thus, the unreleased capital has no entity of its own, and it is questionable whether it could be referred to as a debt on the bank towards the partnership. The bank's commitment to release funds is further weakened sometimes due to there being an overall limit allocated to the client, when the client enjoys other facilities extended by the bank such as *murabahah* and *ijarah*, in addition to the *musharakah*.²⁵ In this instance, the bank would release the capital only if the total exposure towards the client is found to be within the overall limit. Otherwise, the client would be required to settle other dues, thereby bringing down the exposure to acceptable levels, before the bank agrees to release the capital.²⁶

²⁵ In revolving and other credit lines, conventional banks fix an overall maximum limit within which the bank agrees to lend, mainly to business customers. See Obaidullah, 2005, pp 42 and 45. Islamic banks follow the same procedure, and under the limit thus allocated to the client, diverse alternative Islamic facilities are granted.

²⁶ It could be observed that this may indicate a spirit of lending that permeates the relationship of the bank with the client even in *musharakahs*, instead of treating the project as a joint venture.

In the second process, an account is opened in the name of the partnership, usually represented by the client, and the whole capital or part of it is seemingly transferred to it. Although this move is referred to as depositing the capital in the account, upon closer inspection, it appears to be no more than a ledger entry. It is noted that, apart from the differences as dictated by the underlying *musharakah* agreement, the usual procedure employed by conventional banks is followed. The *musharakah* exposure is treated as a credit line as far as banking operations are concerned. Allocation of a portion of available funds does not materialise necessarily, especially if the time of withdrawal is left to the discretion of the client. Rather, release of funds upon demand is ensured through maintaining a cash position sufficient to accommodate withdrawals that could occur normally during the day. The bank may require previous notification from clients if large drawings are to be made in cash. In such instances, if the liquidity of the bank at the time is insufficient to meet the demand, inter-bank borrowing or in the case of some Islamic banks, an Islamic alternative to such borrowing is resorted to. Therefore, liquid funds sufficient to finance the agreed capital contribution need not necessarily be available in the possession of the bank upon forming the equity venture. However, the commitment created through this process could be considered stronger than the first, in that the working partner is free to make drawings at his will, which the bank is bound to honour. In this instance, whether the commitment to release coupled with the possibility of withdrawal is sufficient to fulfil the requirement that the partnership capital be present and available needs verification.

In the operation of this facility, the client is allowed to draw funds from the running account as and when necessary and deposit back excess funds. For profit division, the aggregate of drawings and deposits together with the time the funds remained in circulation is taken into consideration.²⁷ The need for verifying the total amount of capital is thus avoided, as profit is distributed on the basis of the amount of the bank's capital that remained invested in the venture on a daily basis.

The fundamental mechanism utilised here had primarily been adopted by Islamic banks in joint investment accounts for the public, for facilitating investment by a large number of investors at different periods and distribution of profit among them.²⁸ In following this method, frequent fluctuations of the capital comprising multiple infusions and withdrawals is envisaged. This format is proposed as an additional variety of *musharakah* / *mudārabah*, different from other modes. After recognising the validity of such an arrangement in joint investment accounts, it has been apparently extended to include *musharakahs* for long-term financing involving a single customer. However, much of the theoretical details pertaining to this arrangement remain unclear. For the recognition of this

²⁷ See Khan, 1995, p. 35; Tanzilur Rahman, 1999, p. 41.

²⁸ See for details Sadique, 2006, unpublished doctoral thesis.

arrangement as an addition to the known forms of partnership, its fundamental nature including its elements and conditions, its position vis-à-vis the other types of partnership, its similarities and dissimilarities to the latter etc. need to be set out in detail, on which a proper appreciation of it would depend.²⁹

8. CONTEMPORARY SHARĪ‘AH APPROACH

To a large extent, the aspect of existence and presence of capital at commencement of operations in the above modes of financing remains unexplained, possibly due to its multifaceted nature as will be outlined below. Sharī‘a Standards published by the Accounting and Auditing Organization for Islamic Financial Institutions (hereafter referred to as AAOIFI Sharī‘a Standards), in describing the basis for *Sharī‘ah* rulings on *sharikah*, upholds that investments of the parties should be properly determined, as failure to do so will lead to ambiguity in respect to the capital. It asserts that it is not permissible that the capital of *sharikah* be ambiguous, since certainty as to the amount of capital is a benchmark for sharing profit. In general rulings pertaining to capital of *sharikah*, it maintains that the share of each partner in the capital should be determined, whether it is contributed in the form of one lump sum or by more than one payment over time, i.e. when there is a need for additional funds to increase the capital.³⁰ Here, determining the share or amount of capital seems to be a reference to mentioning it in the agreement. It is not made clear whether the capital should exist or be available at the outset and if so, how this should be ensured. AAOIFI Accounting Standards, in a clearer reference, states under basis for conclusions on *mushārah* financing that the *mushārah* capital is governed by a group of principles. The most significant of these are enumerated as: that the share of each partner should be known, specified and agreed as to its amount at the time of contracting; the share of capital of each partner should be available at the time of contracting; it cannot be in the form of a debt on account, etc.³¹ This seems to require presence of capital at the time of contracting itself, based on the more stringent position found in some schools of Islamic law. However, the purport thereof is unclear. The standards themselves do not bear any reference to existence

²⁹ The contract of *mufāwah* as recognized by Ḥanafī jurists, despite not being readily practicable (see Ibn ‘Ābidīn, 1979, vol. 4, p. 307, and *al-Majallah*, vol. 1, p. 255), was discussed in such meticulous detail that sometimes the discussion on it is noted to exceed that on *‘inān*. The only reason for this could be that once it was recognised as a valid form of partnership, it had to be studied and explained from all angles, so that no facet of its theoretical position is left ambiguous, and its relation to other forms of partnership is distinctly set out.

³⁰ (AAOIFI), *Sharī‘a Standards* Safar 1423H – May 2002, Bahrain, 219, p. 202.

³¹ AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Safar, 1423H – April 2002, Bahrain, p. 185.

or availability of capital, apart from guidelines on how the bank's share in the capital should be recognised or measured for accounting purposes at the time of contracting and at the end of the financial period.³²

Sharī'ah boards of Islamic banks do not appear to have addressed this issue in detail. A ruling issued by the Sharī'ah Board of Kuwait Finance House has emphasised on the existence of capital enabling immediate investment in *al-māl*, and has underscored that the shares of both parties should be in this form. Another *fatwā* issued by the same body seems to have approved of gradual accumulation of capital provided actual payment takes place. However, in answer to a query ascertaining partnership capital through summing up drawings made from an account opened in the name of the venture and deposits made into it, the board disapproves of the procedure considering it to be based on ledger entries and emphasises on submission of capital (*taslīm*). It observes that when the capital may not be in the form of debt, it could never be reduced to a mere entry. Capital should comprise of the actual amounts paid by the bank and the client towards the partnership.³⁴ These seem imprecise on the issue in question, as the form in which existence or availability should be ensured is not made clear.

9. OBSERVATIONS ON ENSURING EXISTENCE AND PRESENCE OF CAPITAL

It is apparent that a level of discrepancy exists in the approaches adopted above on the issue of existence and presence of capital. While presence of capital and determining the share of each partner has apparently been considered necessary, some forms of the modus operandi approved appear not to result in realising these aspects. Some of the above *fatāwā* indicate that availability of the amount needed for a particular expense at a given time is sufficient, although the capital is not available as a whole in the beginning stages. Some appear to favour the totalling of disbursements made by the partners towards partnership operations for arriving at the gross amount of capital invested by each partner, even though these may have taken place over a period. This implies that the total capital, and possibly the capital share of each partner, was not known at the outset. As evident, this could result in ascertaining the total capital invested as well as the proportion of investment only at the end of the tenure. However, the shari'ah basis for this inference is not clear, unless if each operation is considered as an individual *mushārah*.

A fundamental factor relevant in this regard could be the possibility of identifying a stock of cash as the capital basis of the partnership, as apparently

³² AAOIFI, Accounting Standards April 2002, pp. 168-9.

³³ Sharī'ah Board of the Kuwait Finance House, 1989, vol. 1, p. 320.

³⁴ Sharī'ah Board of the Kuwait Finance House, 1989, vol. 1, pp 336 and 338.

required in the texts of Islamic schools of law. As shown above, the concept of capital as can be comprehended from Islamic legal texts implies a specific stock of stock of money, either pooled together or lying with each partner, that forms the the basis of the partnership. Perception of money as invariably related to existent existent currency such as gold and silver coins appears to have played a role in many of the rulings in this regard. However, a survey of the contemporary scene scene of commerce and finance poses a significant query pertaining to the identity of money in the current context, and how this should be allowed to influence verification of the existence and presence of capital.

10. HAS THE IDENTITY OF MONEY ALTERED?

While allocating a stock of cash towards an equity venture was not unfamiliar or pose difficulties in the former times, today, the identity and perception of money seem to have undergone substantial change. Therefore, it is necessary to examine the nature of money in the current context. Definition of money has always been a source of controversy and confusion.³⁵ During the period gold and silver coinage were in circulation, monetary value was always synonymous with the amount of gold and silver representing it. Metallic coins too were not different in that they had an intrinsic value and were always attached to either gold or silver, representing fractions of the value of either of them.³⁶ With the advent of banknotes, initially in the form of credit money issued against deposits of gold and silver, and later as fiat money where the value was based solely on government decree and market demand, the distinct identity enjoyed by money underwent a significant deterioration. Although units of paper money issued by state-acknowledged monetary authorities remained the basic unit of currency that formed the core of monetary value, their role and involvement in the traditional money related functions recorded a steady decline. Money, especially in the context of exchange and transaction, increasingly came to be identified as units of value, its connection to the material units of paper not being as accentuated as before.

The prevalence of bank accounts, with the accompanying modes of transfer such as cheques and drafts, coupled with other financial instruments resembling money, eroded the utility of paper money significantly. Electronic facilities of transfer too helped to change the form of money, and have broadened the definition of money.³⁷ Paperless modes of settlement such as credit cards added to this process. Thus, today a large portion of transfer of monetary value does not involve the movement of currency notes. Indeed, cash now amounts to only one per cent

³⁵ Mayer, 1981, p. 276.

³⁶ For a comparison of the functions of gold *dinars*, silver *dirhams* and *fulūs* with that of contemporary fiat currency, albeit in the context of indexation, see Khan, 2002.

³⁷ Miller & Pulsinelli, 1985, p. 7; Makinen, 1981, p. 461.

of the total value of monetary transactions.³⁸ The outcome of these circumstances is that the bulk of payments involve transfer of obligations and liabilities, created on the basis of credit, rather than money. Transactions requiring payment of money are carried out through transfer of credit, disposal of cash, if ever, taking place only at the end of a chain of transfers. Thus, money today, as suggested by some economists, is essentially an abstract measure of value.³⁹ Credit is an invaluable supplement to money today.⁴⁰

A chief architect of this altered state of affairs could be the process of credit creation given rise to by the banking industry. Following this procedure, conventional banks produce credit money through lending and the creation of deposits.⁴¹ Multiple credit lines are created, that are not necessarily backed by a specific portion of real assets allocated towards each commitment, in the well-known process referred to as fractional reserve banking. Curtailed movement of real money, that is, gold and silver coinage as in the past and more recently, notes of fiat currency, and wide circulation of cheques and drafts and other money-like instruments seem to have facilitated banks multiplying their lending capacity manifold. When the banking industry is taken as a whole, facilities far exceeding the actual liquid assets available are extended to clients, due to the assurance that meeting all the commitments thus created would not become necessary at one time. Thus, credit facilities offered remain as abstract commitments made by the bank, which do not take a tangible form except when withdrawals are made in cash. The situation is not significantly different, even in the case of some Islamic facilities offered by Islamic financial institutions. This state of affairs could partially be the basis for the observation made by some that, following the line of conventional banks, Islamic banks too subscribe to the process of credit creation.⁴² The new forms of money thus created are not simply credit in the sense of deferred payment. Rather, these credits are money, that circulate as means of payment.⁴³ The general

³⁸ Ingham, 2004, p. 5, quoting *The Guardian*, 17 April 2000.

³⁹ Ingham 2004, p. 56.

⁴⁰ Microsoft Corporation, 2003.

⁴¹ Ingham, 2004, p. 27.

⁴² Tarek El Diwany, "Travelling the wrong road patiently," *Banker Middle East*, Sep. 2003, <<http://www.islamic-finance.com>> viewed on 23.04.2005; Volker Nienhaus argues that as long as Islamic banking operates with a reserve requirement of less than 100 per cent, there will be money creation, and as such, it is no different from an interest based banking system (Nienhaus, 1986, cited in Akacem & Gilliam, 2002). Whether partial similarity to a fractional reserve system should necessarily result in credit creation needs further study.

⁴³ Ingham, 2004, p. 38.

outcome of this process is observed to be an unnatural expansion of the money supply, a major cause of inflation.⁴⁴

In the context of these altered conditions affecting money and monetary value, ensuring the presence of a stock of money forming the capital of *mushārah* at the outset, although not impossible, could be demanding. A precise assessment of the altered nature of money and its relationship to debt and credit, on which any solution to this question would depend, requires a specific study involving the fields of economics and finance. A research on this topic, possibly conducted by a body comprising experts in these fields as well as *Sharī'ah* scholars could prove to be a timely contribution to the development of Islamic economics and finance. It could be observed *a priori* that the Islamic *Sharī'ah* aims at achieving distinct economic goals including checking inflation at the macro level, through measures such as prohibition of interest, discouraging monopoly and hoarding, promotion of transactions involving real goods and services in preference to money alone and derivatives, stress on delivery and possession in sales, etc. The emphasis placed by the *Sharī'ah* on having real assets, instead of debts, as the capital base in partnerships, could well indicate another important link in a system intended to realise economic good in general.

The above pertains to the form in which existence and presence of capital at the outset could materialise. However, regardless of the form, the fact that the capital should exist and be present is emphasised in all the schools of Islamic law. Although the method employed for ascertaining this could possibly vary based on the altered nature of the identity of money, which should be verified through a specific study not attempted here, the ruling on existence and presence of capital itself could not be totally disregarded, without providing adequate justification.

11. CONCLUSION

While classical and contemporary *Sharī'ah* verdicts regard the availability of capital and determining the share of each partner necessary, some operational procedures adopted generally appear not to realise these aspects. The reason could be that while allocating a stock of cash towards an equity venture did not pose difficulties in the former times, today, the identity of money has undergone substantial change. Credit has come to supplement money, where credit creation by banks has played a major role. Therefore, the form in which presence of money should be ensured would depend on verifying the exact nature of money in the current context. The emphasis placed by the *Sharī'ah* on having real assets,

⁴⁴ According to monetarist theory, inflation is always a monetary phenomenon set in motion by a rise in the money stock or its growth rate relating to the growth rate of real output. See Makinen, 1981.

instead of debts, as the capital base in partnerships, could have important economic implications.

An assessment of the change in the essence and nature of money in the current context needs to be carried out, for verifying the *Sharī'ah* implications of this phenomenon. For carrying out this task, a body comprising both experts in *Sharī'ah* as well as economists and academicians conversant with the monetary theory in *Sharī'ah* could be formulated. Although partial attempts have been made by individual scholars, a comprehensive study from an Islamic perspective taking note of the economic and financial connotations, is necessary for perceiving the extent of the impact of the merger between money and credit / debt in the modern fiscal environment, on *Sharī'ah* rulings involving money. This could shed light on various issues related to the study, such as the form in which monetary capital should exist at the formation of equity ventures, and the involvement of credit / debt capital. Rulings formulated without undertaking an assessment of this nature cannot be expected to provide satisfactory solutions that are consistent. It could be observed *a priori* that the importance given to the existence and availability of capital on occasions such as at the outset of equity ventures may possibly signify another *Sharī'ah* measure having far-reaching effects on macro factors such as monetary expansion and inflation.

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