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# Assigning Capital in Equity Based Financing Ventures: The Practice of Interest Free Banks

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## ABSTRACT

The interest-free mode of financing championed by Islamic banks in general worldwide favour investment on joint equity basis for generating profits, as against lending for earning interest income. In this process, the general requirement is that a stock of cash form the equity basis of the joint ventures, as against debt forming such basis. However, some operational procedures adopted by current-day interest-free financial institutions in the course of financing undertaken on joint-equity basis generally appear to fall short in this respect. A major 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. This research suggests that an Islamic law based assessment of the change in the essence and nature of money in the current context needs to be carried out, for verifying the legal implications of this phenomenon.

## INTRODUCTION

Although the general requirement pertaining to capital in equity based commercial ventures in Islamic law is that it should be based on cash, in observing the practical scenario involving some forms of equity finance practised by interest-free banks, implementation of such aspects raises questions. It is seen that in many instances, release of the funds by the financial institution for such ventures occurs gradually, and only an agreement to contribute made by the bank exists at the inception of the equity venture. Alternatively, a running account is opened in the name of the venture, allowing the client to draw the capital as and when necessary. Both contexts raise the issues of existence and availability of capital at commencement of the venture, given as a requirement in the relevant legal texts.

The discussion below seeks to verify the textual position of Islamic law on the issue of existence and presence of capital along with the approach of the modern boards of fatwa or legal verdict, and to examine the extent to which this is reflected in the practice of interest-free banks. Thereafter, the paper goes on to analyse the issue in the context of the modern concept regarding the nature of money, and to suggest possible economic connotations that may explain the shari‘ah directive.

### Practice of interest-free banks in allocating equity capital

With regard to Islamic financial institutions, the issue of the existence of capital is of especial relevance in the case of temporary equity relationships created by the bank with its clients on partnership or investment basis, for purposes such as financing of single transactions and project financing. Therefore, we shall proceed to analyse such relationships in particular, which could be in the form of either financing the whole portfolio on the basis of investment or partial equity participation on partnership. At times it could even be an admixture of these two modes, where the outcome would essentially reflect aspects of both partnership

and investment, in the proportion of capital participation reflective of each mode.

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 even be released in full at the inception itself. However, if the relationship involves a relatively longer-term commitment such as project financing, more often than not, release of the funds 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 inception of the equity venture, as borne out by the basic partnership agreement. Thereafter the working partner, i.e. the client, initiates operations through investing his own funds. Indeed, some financial institutions require that the capital contribution of the client be fully invested first and be materially absorbed in the venture prior the bank releasing its capital share. This is justified as a measure for ensuring the earnestness of the client and securing the interests of the bank against the partner's lack of diligence, which is of especial relevance in partnership as against interest-based lending. The subsequent release of funds could take place on an agreed future date, or a specific schedule could be drawn for the release of capital in stages. It could even be made dependant on demand made by the working partner based on the needs of the venture. Thus, it is apparent that where this course is adopted, the only capital available at the initiation of operations is that of one partner, i.e. the client, the commitment of the bank being limited to an agreement to supply its share in the future. Consequently, the input of one of the partners could be regarded absent at the inception.

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 in this regard that, apart from the differences as dictated by the underlying joint equity venture agreement, the usual procedure employed by conventional banks is followed, with the joint equity venture exposure treated as a credit line as far as banking operations are concerned. The facility thus granted is identified as a liability on the bank, while 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 accommodate withdrawals that could occur normally during the day. Many banks require previous notification from clients if large withdrawals are to be made. 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 interest-free 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 withdrawals 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. 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 interest-free banks in public joint investment funds, for facilitating investment to a large number of investors at different periods and distribution of profit among them. In following this method, frequent fluctuations of the capital comprising multiple infusions and withdrawals is envisaged. In fact, employing this method ensues from recognising such fluctuations as valid. This is proposed as an additional variety of partnership / investment, different

from other modes. After recognising the validity of such an arrangement in joint investment accounts, it has been apparently extended to include joint equity ventures 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 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 be set out in detail, on which a proper appreciation of it would depend.

**Existence of capital in modern fatawa verdicts**

To a large extent, the aspect of existence and availability 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. Shari‘a Standards published by the Accounting and Auditing Organization for Islamic Financial Institutions (hereafter referred to as AAOIFI Shari‘a Standards), in describing the basis for Islamic legal rulings on partnership, 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 sharika be ambiguous, since certainty as to the amount of capital is a benchmark for sharing profit. In general rulings pertaining to capital of sharika, 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.[1] 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 musharaka financing that the musharaka 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.[2] This seems to require availability 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 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.[3]

Supervisory boards of interest-free banks are not generally observed to have addressed this issue in detail. A ruling issued by the Supervisory Board of Kuwait Finance House has emphasised on the existence of capital enabling immediate investment in partnership al-mal, and has underscored that the shares of both parties should be in this form.[4] Another fatwa issued by the same body seems to have approved of gradual release of capital provided actual payment takes place. However, in answer to a query on 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 (in Arabic *taslim*). 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.[5] These seem imprecise on the issue in question, as the form in which existence or availability should be ensured is not made clear. As mentioned in the relevant texts, submission of capital to the partner is not required, especially in Hanafi school. A monetary partnership is required to be initiated with a present and available capital, even though in the possession of the partners themselves.

**The origin of the issue**

A level of discrepancy exists in the approaches adopted above on the issue of existence and availability of capital. While availability 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

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aspects. Some of the above fatawa 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 joint equity venture.

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 required in the texts of Islamic schools of law. The concept of capital as can be comprehended from Islamic legal texts implies a specific stock of money, either pooled together or lying with each partner, that forms the basis of the partnership. Perception of money as invariably related to 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 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 availability of capital.

**Identity of money**

The identity and perception of money seem to have undergone substantial change, which appears significant in the context of allocating a stock of cash as equity capital. 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.[6] During the period gold and silver coinage was 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.[7] 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.[8] 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 of the total value of monetary transactions.[9] 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.[10] Credit is an invaluable supplement to money today.[11]

A major reason 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.[12] 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 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.[13] The general outcome of this process could be observed to be an unnatural expansion of money supply, a major cause of inflation.[14] Even in the context of Islamic equity financing, the basic modus operandi appears not be significantly different from what is found in conventional banking. This could partially be the basis for the observation made by some that, following the line of conventional banks, interest-free banks too subscribe to the process of credit creation.[15]

In the context of these altered conditions affecting money and monetary value, ensuring the presence of a stock of money forming the capital of joint equity venture at the outset, although not impossible, could be challenging. However, a precise assessment of the altered nature of money and its relationship to debt / credit, on which any solution to this question would depend, requires a specific study also involving the fields of economics and finance. An investigation as to the impact of this issue is not attempted here, as the current study is limited to verifying the shari'ah perspective of equity based transactional modes of interest-free banks. However, it could be observed in this regard that the Islamic shari'ah aims at achieving distinct financial 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 abstract rights and derivatives, stress on delivery and possession in sales, etc. The emphasis placed by the shari'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 the existence and availability of capital at the outset could materialise. Irrespective of the form, the fact that the capital should exist and be available is emphasised in all the schools of Islamic law. Although the method employed for ascertaining existence and availability could vary based on the altered nature of the identity of money, which should be verified through a specific study not attempted here, availability of capital at the outset could not be totally disregarded without providing adequate justification.

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.

## CONCLUSIONS

There appears a strong possibility that equity financing structures currently adopted could be developed further to ensure a higher level of ethical and legal conformity while curing some of the negative aspects, so that their full potential could be adequately revealed. The nature of the Islamic law requirement that capital in partnerships be existent and present at the outset and the possibility of its realisation in the modern fiscal environment need to be examined, especially in the context of deeper connotations it may carry with regard

to constancy and stability of money supply. The altered nature of money and monetary value has lead to a progressive degeneration of the demarcation between money and debt. The potential results of an economic nature related to this phenomenon through possible promotion of the credit creation mechanism need further scrutiny. The answer could lie in a precise Islamic legal assessment of the altered identity of money and its relationship to debt in the current fiscal environment.

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## FOOTNOTES

[1] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari'a Standards* Safar 2010, Bahrain, pp. 219, 202.

[2] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* 2010,

Bahrain, p. 185.

[3] AAOIFI, Accounting Standards 2010, pp. 168, 169.

[4] Shari'ah Board of the Kuwait Finance House, *al-Fatawa al-Shar'iyyah fi al-Masa'il al-iqtisadiyyah*, vol. 1, p. 320.

[5] Shari'ah Board of the Kuwait Finance House, *al-Fatawa al-Shar'iyyah fi al-Masa'il al-iqtisadiyyah*, Kuwait, Kuwait Finance House, 1989, vol. 1, p. 336, 338.

[6] Thomas Mayer, *Money, Banking and the Economy*, New York, W W Norton Co, 1981, p. 276.

[7] For a comparison of the functions of gold dinars, silver dirhams and fulus with that of contemporary fiat currency, albeit in the context of indexation, see Waqar Masood Khan, *Transition to a Riba Free Economy*, Islamabad, International Institute of Islamic Thought, 2002.

[8] Roger LeRoy Miller & Robert W Pulsinelli, *Modern Money and Banking*, New York, MacGrow Hill, 1985, p. 7, Gail E Makinen, *Money, Banking and Economic Activity*, New York, Academic Press, 1981, p. 461.

[9] Geoffrey Ingham, *The Nature of Money*, Cambridge, Polity Press, 2004, p. 5, quoting The Guardian, 17 April 2000.

[10] Ingham above, p. 56.

[11] *Microsoft Encarta Encyclopedia* 2003, Microsoft Corporation, "money."

[12] Ingham above, p. 27.

[13] Ingham above, p. 38.

[14] 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 above.

[15] Tarek El Diwany, "Travelling the wrong road patiently," in *Banker Middle East*, Sep. 2003.