Composition of Capital Basis as Postulated in Interest-Free Financing Systems: The Islamic Legal Approach

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ABSTRACT

In the aftermath of the states of financial instability that had occurred repetitively in the past decades, it is imperative that academic studies be undertaken on alternative systems for financial management available in other legal traditions. In this regard, relevant features of interest-free financial systems such as the mode put forward by Islam, can be a rich field for research and analysis. The current paper is an explorative attempt to probe the reasons and wisdom behind the stress placed on the existence and presence of capital at the commencement of joint equity ventures in the Islamic legal precepts. A perusal of classical and contemporary Islamic verdicts pertaining to equity capital in joint ventures would reveal that the presence of capital in the initial stages of the partnership is held as a necessary requirement. Classical jurists had placed extraordinary emphasis on the existence and the presence of capital at the inception of a partnership venture. Debts have been categorically disallowed from forming the initial basis of a partnership. This research suggests that the emphasis placed by Islamic law on having real assets, instead of debts, as the capital base in partnerships, could have important economic connotations, such as acting as a curb on unrestrained monetary expansion and inflation.

Keywords: partnership, Islamic law, capital, interest-free, financing

INTRODUCTION

The financial crises that occurred in the past decades severely affecting the economies of a number of nations, as well as future financial meltdowns said to be looming in the horizon,[1] have generated a keen interest on the part of academics as well as policy makers, in taking a fresh look at the prevalent economic system. In particular, the current financial system that is considered to have paved the way for the such crises by facilitating an ever-expanding mismatch between the money supply and the real economy has come under increased scrutiny. The so-called debt-ridden money, which is out of proportion to the real assets and commodities underlying it, was allowed to expand in an unregulated manner, until the final rupture became inevitable.

In contemplating possible means that could control and regulate unhealthy expansion of the money supply, our attention is drawn to certain hitherto little-understood regulations available in Islamic law, that pertain to the nature of capital in joint ventures. The texts of Islamic law seem to place much emphasis on the existence and presence of capital at the outset of a business venture based on joint equity. They also indicate that the capital in such joint ventures may not be in the form of debt.

While emphasised in the texts of Islamic law and adhered to in former times, these rules appear to have become gradually neglected in the process of the transition that took place in monetary currency over the latter

[1] "The looming global debt disaster," Indermit Gill, https://blogs.worldbank.org/en/voices/the-looming-global-debt-disaster, June 09, 2025; "The impending financial crisis," Jeffrey N Gordon, https://blogs.law.ox.ac.uk/oblb/blog-post/2024/11/ impending-financial-crisis, 20 November 2024.

century. In the aftermath of the recent financial crises, a review of the relevance of these regulations can be expected to be beneficial in appreciating their possible underlying wisdom.

Although the topics demands a broader approach, for reasons of brevity, the scope of the current paper is limited to the nature of capital in equity relationships as expounded in Islamic legal sources, especially in the context of its relevance to joint participatory financing modes employed by Islamic banks with clients based on partnership or investment.The current research is exploratory in nature, not aimed at presenting immediate workable solutions, which task requires joint effort by a team of experts well-versed in all of the relevant areas who could combine their expertise for the purpose. Rather, the present attempt is aimed at kindling the interest of academics and researchers to conducting in-depth analyses in the subject area, for assessing the relevant material and drawing guidelines from them, that could ultimately lead to the realization of the above.

Islamic legal texts on existence and presence of capital

Islamic legal texts apparently agree on the fundamental issue that the capital in equity based partnerships should necessarily be existent and available for the validity of the contract, although there is a level of difference 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. In the discussion below, we shall attempt at examining the position upheld by the schools of Islamic law as reflected in their major texts.

With regard to the existence and availability of the capital at the inception of the contract, the Shafi‘i school of Islamic law is noted for the stress it places on this aspect, more than others. Shafi‘i jurists deem the occurrence of a foregoing proprietary partnership essential for the formation of a valid contractual partnership. As such, the presence of jointly owned capital is imperative for partnership in assets. 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 partnership. Only jointly owned property is acceptable, where the partners share the ownership in every unit of the capital or individual units belonging to each partner are not distinguishable from that of others, for the sake of ensuring joint liability in a factual manner.[2] This follows the position maintained by this school that units of monetary currency are distinct entities, where particularization, i.e. distinct legal identification of a particular unit, is possible.

Therefore, the imposition of this condition necessitates the existence and availability of the capital in a precise manner at the inception itself for commencing a partnership, in the Shafi‘i school. This appears to be the case even when the capital is ‘unique’, i.e. non-fungible, as against generic commodities. Here, even if the legal device suggested by Shafi‘i jurists is followed, where the potential partners enter into a sale of barter exchanging shares of their assets in a specified proportion to establish a proprietary partnership, the validity of such a sale entails taking possession of the exchanged shares in the prescribed manner. The latter step invariably requires the presence and availability of the capital in full, even before the commencement of the partnership. Thus, the possibility of contracting a partnership based on capital that is not specific and identified is ruled out. Similarly, a debt could never qualify as capital.

The position of the Hanbali school of law appears similar to the Shafi‘is in this respect. The Hanbali school, too, does not allow the formation of partnership when the capital is absent, as it hinders immediate commencement of operations. According to Ibn Qudamah, it is not permitted that the capital be comprised of funds that are absent or a debt, as in this event, initiating transactions at once, which is the objective of partnership, is not possible.[3] Thus, in the view of Hanbali jurists the contract of partnership should be capable of being executed instantaneously, and absence of capital that hinders this function is impermissible. However, a second opinion of the Hanbali school considers the presence of the capital of one of the partners at the inception sufficient for the proper formation of general partnership.[4]

2 See al-Ramli, *Nihayah al-Muhtaj*, vol. 5, p. 7.

3 Ibn Qudamah, *al-Mughni*, vol. 5, p. 127.

4 Abu al-Hasan al-Mardawi, *al-Insaf*, Beirut, Dar Ihya al-Turath al-Arabi, vol. 5, p. 408.

The Maliki school of Islamic law differs somewhat from the above position in that it appears to recognise the possibility of forming a valid partnership 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.[5] Therefore, a debt may not become capital in partnership. Presence 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.[6] Maliki jurists have thus overlooked the occurrence of a slight delay in the implementation of the partnership 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, Maliki jurists 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.[7] This would mean that the capital becomes limited to the amount that was present.[8]

The Hanafi school of law too has insisted on the existence and prescence of the capital for the validity of partnership, however, in a somewhat different manner. According to al-Kasani, the capital should be tangible and present, and may not be a debt or absent property.[9] The Hanafi jurist al-Haskafi states that this ruling is common to partnerships based on both major varieties.[10] However, although Hanafi jurists stress on the presence of capital for the legitimacy of partnership, they have not insisted that it be present at the time of contracting itself. On the contrary, the availability of capital at the commencement of operations has been considered sufficient for the fulfilment of this requirement. In his explanatory note on the above ruling that partnership is not valid on capital that is absent, Ibn ‘Abidin has categorically stated that what is meant by presence of capital is its presence at the contract of purchase. Presence at the contract of partnership is not intended, as the latter is valid even if the capital is not existent at the time of contract.[11] Although another position maintained by some Hanafi 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 ‘Abidin is observed to have given preference to the first. The same is reiterated by al-Kasani, who states that the presence of capital is a condition at purchase (i.e. at commencing operations) and not at the contract of partnership. Presence of capital at the point of purchase has been taken into consideration because the contract of partnership is finalised with purchase.[12] Al-Sarakhsi too stresses that the partners producing the capitals specifically distinguishing/identifying it at the time of contracting or transacting is a condition for the validity of partnership.[13]

Considering the above, it is clear that the schools of Islamic law regard it mandatory that the capital exist at the commencement of a partnership. The minor difference in this regard as far as the Hanafi ruling is concerned is due to the fact that according to the latter, the factual commencement is considered to take place once the partners start operations. Thus, The Hanafi school requires existence of capital at this point.

Existence of capital in equity financing by Islamic interest-free banks

It would be pertinent to examine here the modus oparandi employed by banks in financing ventures, in order to verify the reality of capital and its factual nature upon such financing is commenced. Subsequent to the credit verification and negotiating processes, approval for the joint-equity facility is granted, and the stage of actual financing starts. From among the usual variations adopted here, two may stand prominent. One is where the

5 Al-Khurashi, *Hashiyah al-Khurashi*, vol. 6, p. 342.

6 Ahmad al-Dardir, *al-Sharh al-Kabir*, Beirut, Dar al-Fikr, vol. 3, p. 350.

7 Sahnun ibn Sa‘id, *Al-Mudawwanah al-Kubra*, Beirut, Dar Sadir, vol. 12, p. 62.

8 A similar position is adopted by Shafi‘i jurists when part of the capital is withdrawn before commencing operations. See al-Sharbini, *Mughni al-Muhtaj*, vol. 2, p. 432.

9 al-Kasani, *Bada’i‘ al-Sana’i‘*, vol. 6, p. 96.

10 ‘Ala al-Din al-Haskafi, *al-Durr al-Mukhtar*, printed with *Radd al-Muhtar*, Beirut, Darul Fikr, 1979, vol. 4, p. 311.

11 Ibn ‘Abidin, *Radd al-Muhtar*, vol. 4, p. 311.

12 Al-Kasani, *Bada’i‘ al-Sana’i‘*, vol. 6, p. 96.

13 Abu Bakr al-Sarkhasi, *al-Mabsut*, Beirut, Dar al-Ma‘rifah, 1406H, vol. 11, p. 152.

capital is released by the bank for financing transactions. In financing relatively longer-term joint equity ventures, in the simpler form, the bank may 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, the start of operations of the joint venture occurs through conducting an initial transaction on behalf of the joint equity venture, which is usually done by the client through his own capital or through an initial release of funds by the bank. When looked at from the perspective the existence and presence of capital, at the instance when the venture sets off in this manner, the status of the rest of the capital apart from the amount thus mobilized in the initial transaction remains uncertain. The unreleased capital is only represented by the obligation on the bank created by the joint equity venture 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 commitment on the bank 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 cost-plus sale and lease, in addition to the joint equity venture. 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.

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. This facilitates keeping the funds at the disposal of the working partner, enabling him to draw the capital as and when necessary. This could be regarded as an operational practice Islamic banks have acquired from their conventional counterparts, for providing an Islamic facility similar to conventional credit lines. Here the bank's participation materially occurs in amounts and times decided by the working partner in the future. When this takes place in a partnership setup, it involves the issue of existence and presence of capital at the inception of the partnership. In addition, this procedure raises another critical Islamic law issue. Although an upper limit indicating the maximum cash outlay the bank is willing to undertake towards the partnership is agreed, this may not necessarily reflect the total amount of capital it would invest in the partnership physically. The working partner who is free to draw the capital according to the requirements of the venture is left to determine the extent of involvement of the financial institution. Hence, the total amount drawn by him at different periods could be equal to the limit initially approved or less. Occasionally, it could even exceed the limit, when the consent of the bank is obtained for an increase of its exposure. Consequently, this adds a further dimension to the capital participation issue, in that the precise amount of capital outlay by one of the partners is unknown at the inception of the contract. To complicate matters further from a Islamic law perspective, in addition to drawing the capital in portions as demanded by operational requirements, surplus amounts are deposited by the working partner in the running account, thus returning part of the capital.

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 as required, and whether it was known at the inception.

Debt as capital in the Islamic legal perspective

As evident, the emphasis placed by the Islamic law on the existence and availability of capital at the outset of an equity venture naturally rules out the possibility of capital being in the form of a debt. Jurists of different schools of Islamic law have categorically declared that debt is inadmissible as capital in partnership.[14] Al-Mawardi has explained that when a creditor requests his debtor to invest an amount similar to the debt and commence a joint venture based on both amounts, the partnership is invalid, as the partnership here is based on a debt. A valid partnership may only be formed after the debtor settles the debt and the creditor takes possession of the amount.[15] According to the *Majallah*, when two individuals own a debt on a third, a

[14] Ibn Qudamah, *al-Mughni*, vol. 5, p. 127, al-Kasani, *Bada'i' al-Sana'i'*, vol. 6, p. 96.

[15] Al-Mawardi, *al-Hawi al-Kabir*, vol. 6, p. 482.

partnership may not be formed with the debt as capital, a position generally upheld in all the schools.[16] The importance given to this ruling could be gauged through the fact that while a partnership that entirely lacks capital may be formed as a service or goodwill based partnership according to some schools, creating an equity venture on the basis of debt is not approved. Although capital may turn into debt in the course of an equity venture, initiation of such a partnership with debt alone as capital is expressly disallowed in all the schools of Islamic law. The restriction appears more severe in the case of investment, to the extent that the consensus of Islamic jurists has been recorded on the impermissibility of a creditor converting a debt due to him from another into a investment.[17] As explained by al-Mawardi, the reason for impermissibility is that the contract here takes place over absent capital. In this event, profit or loss resulting from the venture would devolve on the worker, i.e. the debtor, while he will remain liable for the debt.[18] If a creditor wishes to initiate a investment with a person who is currently indebted to him by investing the amount of debt without assigning fresh funds towards the venture, this could be done only after the debtor has settled the debt and the creditor has taken possession of the amount given in settlement. The obvious reason, as expressly stated by the Maliki jurists, is that this step could be resorted to by a debtor who is unable to settle and wishes to gain time through giving an additional sum to the creditor, which according to them is tantamount to interest. They have disallowed the conversion of even a deposit for safekeeping or a pledged asset into capital of investment, due to the same reason. The Shafi'i and Hanafi jurists hold this impermissible due to the fact that a debt may not turn into a non-liability, as is required in the case of investment capital.[19] As evident, these two are mutually exclusive attributes that may not combine over a single asset. A debt is a liability on the debtor, while the capital of investment is not a liability on the entrepreneur in Islamic law, in that he is not required to compensate for its loss under normal circumstances. Jurists other than Malikis have allowed converting funds deposited for safekeeping into capital of investment, as such deposits continue to be owned by the depositor and remain in the hands of the holder of deposit, for which the latter is not liable. However, this is only possible if the deposit had been kept intact. If the holder of deposit had utilised it thereby converting it into a debt on him, it may not become capital in an investment.[20]

It is clear that the concern expressed by the Maliki jurists appear greatly relevant to conversions of debt into partnership/investment as effected by Islamic banks. Here the express purpose of the bank in initiating a partnership with the client who is already indebted to the bank happens to be converting the idle debt into a source of revenue, which would otherwise not be possible. As could be inferred, the client's agreement to this measure is given in the hope of obtaining additional respite in settling the debt and staving off the probable liquidation of security. As funds are not released by the bank towards the venture, it is solely funded by the client, and a profit share is ultimately allocated to the bank in view of the debt that had been due.

Converting debt into capital in the practice of interest-free banks

Conversion of debt into capital could occur usually in the course of the bank's effort to contain the repercussions of adopting debt-financing modes. Such measures are contemplated in the event of default taking place in the payment of cost-plus sale instalments of various types, lease rentals, and even interest-free loans. In the event of non-settlement, all of these transactions result in stagnant debts that are unproductive in their essential nature, affecting the profitability of the bank adversely. Although these could be settled ultimately or recovered through liquidation of mortgages and securities that are invariably available, the financial institutions could only recover the amount that was outstanding at the outset of the default. They may not realise any return for the period the funds remained idle in the form of a debt as far as the involvement of the bank is concerned. Conventional banks, on the other hand, could freely avail of imposing interest at penal rates on defaulters, which could even result in additional gains to the creditor. In the case of Islamic banks, as known, any deterrent penalty the defaulter could be compelled to pay based on a preceding self-obligatory

16 Al-Attasi, *al-Majallah*, vol. 1, p. 257.

17 Ibn Qudamah, *al-Mughni*, vol. 5, p. 190.

18 Al-Mawardi, *al-Hawi al-Kabir*, vol. 7, p. 309.

19 Ibn Rushd al-Qurtubi, *Bidayah al-Mujtahid*, vol. 2, p. 257, al-Khurashi, *Hashiyah al-Khurashi*, vol. 7, p. 148. It appears from the reason stated by the Malikiyyah that a reason for the prohibition is blocking of avenues (*sadd al-dhara'i*') which is a recognised principle according to them.

20 Ibn Qudamah, *al-Mughni*, vol. 5, p. 191.

clause, as sanctioned by a number of Islamic law boards as well as the AAOIFI Shari'a standards, could only be channelled towards charitable avenues.[21] The creditor is expressly prohibited from drawing any benefit from such penalty. Charging of opportunity cost as found in conventional commercial practice is not recognised in Islamic law.[22] In this scenario, such defaults create a significant problem for Islamic financial institutions not faced by their conventional counterparts.

As a consequence of the above, Islamic financial institutions would attempt to minimise unproductiveness of such funds through measures such as initiating partnership ventures based on them, especially when the client happens to be a business firm or own a running business concern. A partnership / investment venture is created with the debtor, where the capital exposure of the bank consists partly or fully of the amount of debt currently outstanding on the client. Through this procedure, the bank hopes to be entitled to a return on the overdue debt by claiming its share of profits in the venture, thus avoiding the possibility of the amount remaining idle until settlement or recovery. Such manoeuvres are not reflected on transactional documents usually, as the records display granting of a partnership / investment facility and the release of funds, whereas in actual fact, the outstanding debt is written off, and no transfer of funds takes place. The involvement of the former debt in the transaction being limited to ledger entries in a different portfolio, documentation of the transaction does not provide any clue about this important aspect. This mechanism involves a number of structural weaknesses such as selecting as partner in a joint venture a client who has proven his inability to fulfil commitments reliably, as well as Islamic legal aspects of concern such as the transformed significance of the collateral obtained initially to secure the debt.

The outcome of the dictate that capital be existent and present

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 partnership, as far as commencing operations is concerned, the schools, including the Hanafi, appear to be in agreement about the fact that the capital should necessarily be available at this point. The Hanafi school, despite 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 investment. The Shafi'i and Hanbali schools require the presence of capital even before. Thus, what could be understood from 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.

However, fulfilling this condition in the contemporary commercial environment could be demanding. 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 partnership 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. If the capital input of both is agreed to be in the form of money, fulfilment of this condition as stipulated appears to dictate reserving a stock of cash as the capital base of the partnership. 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

[21] AAOIFI, *Shari'a Standards 2010*, p. 39.

[22] For a discussion of the Islamic law aspects of penalty of default and opportunity cost, see Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, pp. 131 -137.

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.

CONCLUSIONS

A perusal of Islamic legal texts reveals that considerable emphasis has been placed on the nature of capital contributed towards equity relationships. The existence and availability of capital at the formation of equity partnerships has been regarded mandatory, precluding the possibility of forming partnerships based on debts and non-existent capital. This is seen to result in important consequences pertaining to the involvement and liability of the partners. The practice of Islamic financial institutions in this regard does not appear to reflect the Islamic law rules adequately. In the common practice adopted by these institutions following interest-based banking practice, no emphasis is placed on ensuring prior existence or presence of capital, even in financing ventures on joint equity basis. Sometimes, even existing stagnant debts are seen to form the basis for starting a joint venture with clients. In view of the unanimous prohibition upheld by all the schools of Islamic law, the practice of converting overdue debts into venture capital could hardly be defended. Islamic financial institutions that suffer due to defaults could undertake measures approved by Islamic law for securing their dues without excessive delay, and may even resort to liquidation of securities where this could be justified. However, turning an established debt into an avenue of income in the above manner appears to be incompatible with the Islamic theory of economics. The emphasis placed in Islamic law on the capital being existent and present at the commencement of joint ventures is seen to have important economic connotations, especially in the current context of economic uncertainty and possibility of meltdowns. It can be argued that this ruling could represent an important measure aimed at providing economic stability and certainty at the macro level.

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