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EQUITY-BASED ISLAMIC FINANCE: A PRODUCT DEVELOPMENT PERSPECTIVE

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Abstract

The research is conducted to explore and design mechanisms to shift the focus of Islamic banking and finance practitioners from debt-based modes of Islamic finance like Murabaha, Salam, and Istisna to equity-based or participatory tools of finance like Mudaraba and Musharaka by proposing product structures that can viably substitute the existing products and service offerings of Islamic banking entities which are based on debt-based financing techniques. This is a clear fact that over-reliance of Islamic banks on debt-based products like Murabaha has not contributed positively towards Islamic banking perceptions, so moving to equity-based Islamic finance methods is also vital in this context. The paper discusses some equity-based product propositions in this regard.

Keywords: *Product Development, Islamic Banking, Islamic Finance.*

Introduction

Islamic banking emerged as an alternative and a reckoning force against interest-based banking and financial structure in the second half of the 19th century. Islamic model of economics and finance flourished in the face of severe competition from interest-based financial system which is arguably the root cause of all economic and financial problems, world is confronting. The idea of Islamic economic/financial system is greatly in contrast to the modern interest based economic system which is driven by the principles of capitalism, unbridled resource consumption, individual welfare and materialism. The Islamic system entails collective welfare, ethical business and commercial dealings, and risk-sharing as compared to risk-avoidance behavior of conventional interest-based framework. Islamic framework is based on the Islamic guidelines derived from Holy Quran and the Sunnah (sayings and acts) of the Holy Prophet (PBUH) to eventually facilitate trade and business in the society and to consequently bring economic well-being and prosperity. (Aqib Ali 2014) Islamic financial system, after its origin in 1960s, progressed steadily. This is however, disappointing that Islamic banking and finance system that emerged as an alternative to

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interest-based financial framework flourished swiftly but to a reasonable extent, failed to grasp its true potential in the broader perspective. One of the chief reasons behind non-realization of full potential of Islamic finance paradigm is the adaptation of debt-based financing by Islamic banking and finance institutions, the research paper addresses this issue by suggesting some propositions to shift focus towards equity-based financial models that are truly Shariah compliant and represent the essence of Islamic finance system.

Islamic Banking & Finance – An Overview

The Islamic or interest-free financial setup originated in the early 19th century in the Muslim population of the sub-continent (Iqbal & Mirakhor 2011), afterwards the initiatives like Mit Ghamr in Egypt in 1963 and Tabung Haji in Malaysia further strengthened the Islamic finance paradigm. As time passed, the Islamic banking and finance setup grew bigger and stronger. The first international Islamic financial institute was the Islamic Development Bank (IDB) in 1975. This was a landmark in the history of Islamic banking. Some countries including Pakistan, Iran, Sudan, Malaysia and Bahrain initiated efforts to implement Islamic banking at larger scales in their respective countries during 1980s. In the next decade some of the conventional banks also introduced Islamic banking products and services by operating separate Islamic banking units and divisions. After the foundations of Islamic banking in countries like Egypt and Malaysia, it became evident that Islamic banking will have a vivid future. Swiftly after the introduction of Islamic financial services by the conventional banks, Islamic banking started to make its mark on the global financial landscape. (Khan & Bhatti 2008). The capacity and vigor of the industry has now reached to more than 500 banking and financial entities having operations in over 90 countries with the aggregate gross assets approximately more than 1.6 trillion US dollars which is likely to double by 2016. (Humayun 2013). The growth rate stands at a staggering more than 16% a year. According to Kapur (2008), most of the large Islamic finance entities including Islamic banks have outperformed and outpaced their conventional counterparts – the conventional interest based banks with the assets growth rate of more than 26.6 per cent with assets growth standing at an amazing 350 billion US dollars approximately, as compared to the mainstream banks who stood at an asset growth rate of 19.3 per cent. With the passage of time, Islamic finance flourished, innovative and diverse products and services like sukuk, Islamic mutual funds, and takaful fortified Islamic finance at international level. (Aqib Ali 2015)

Despite all the growth and achievements, this is also a truth that Islamic banking and finance paradigm has failed to reach its full potential. This is chiefly because of two major factors; first is the lax research and development which lead towards slack product development and the second factor being less consideration towards Shariah objectives which leads towards negative perceptions towards Islamic finance. Ahmed (2011) opined that contemporary procedures and field practices of Islamic system of banking and finance are criticized for not fulfilling the objectives of Shariah. The current product offerings of Islamic banks and financial institutions are dominated by debt-based structures and mechanisms like murabaha, salam and Istisna. Al-Amine (2015) argued that the best way to strengthen the use of profit and loss sharing products is to innovate the best equity based investment alternatives which are still below their potential such as venture capital, private equity, asset management and to work towards deepening the stock markets, this can only be achieved by equity and participatory finance modeling. The research paper endeavors to suggest product arrangements based on Mudaraba and Musharaka structures as opposed to the debt-based models to bring a greater degree of Shariah compliance in product assortment of Islamic finance entities, to eventually create a positive image and to enhance the stakeholder perceptions regarding Islamic finance paradigm.

Analysis of Products Assortment of Islamic Banks

The Islamic modes of finance can be broadly categorized into two main categories, first are the equity based or participatory modes like Mudaraba and Musharaka while the second category includes trade based modes like ijarah, salam, istisna and murabaha. Although the trade-based modes are not loans in real terms, yet these create debts on the basis of deferred sales. (Taqi Usmani 1999) If we survey the prevailing products and offerings of Islamic banks operating globally, we can clearly draw a conclusion that most of these offerings and services are based on debt-creating mechanism e.g. murabaha, and other deferred sale transaction models like bai bithaman ajil (BBA), and Istisna. On the contrary, the essence of Shariah-compliant banking is risk-sharing and business partnership which is embedded in participatory or equity-based mechanism like the Musharaka and Mudaraba. Among present product structures in Islamic finance, murabahah leads all others, it is arguably the most used mode of Islamic finance, according to Obaidullah (2005) it is a tool of finance that is actually a special kind of sale (Muhammad, Yusof & Hezlina 2011) in which both cost and profit are expressly stated. Murabaha leads the financing arrangements of Islamic banks globally. According to the Islamic Banking Bulletin of SBP (March 2013), murabaha leads the financing share mix of Islamic banks in Pakistan which is 36%, in financing mix of IBIs (Islamic banking institutions) and IFIs in Malaysia and Bahrain is more than 54% (Abdus Samad, Norman, Gardner and Cook 2005), and in Sudan it is over 43%. According to Rahman (2016), murabaha accounts for 75% of all financing arrangements in UAE. Apart from this, murabaha is a preferred choice for Islamic finance practitioner i.e. Islamic bankers to finance short-term to medium-term financing requirements in both corporate and consumer finance sectors. Whereas vehicle financing and house financing is also executed through murabaha/bai bithamman ajil in Malaysia and Bangladesh. Ijarah as an Islamic mode of financing is also utilized for financing of houses, cars and other such commodities and assets in various Islamic banking industries in countries like Pakistan and UAE. Apart from commodities and asset financing through murabaha, letters of credit (LCs) and foreign trade transactions, trading of materials and inventories are also transacted and financed using murabaha models. Tarik (2004) mentioned in his work regarding domination of murabaha in Islamic finance and examined that the “murabah syndrome” has dominated Islamic banks’ product assortment almost everywhere Islamic banking is in operation and notes that because of this factor divergence exists between the theory of equity-based financing and the common practices of Islamic banks. Apart from murabaha, Islamic banks and non-banking Islamic finance entities use forward-sale mechanism like Salam and Istisna also; both are debt-based. Salam is exclusively employed for the purposes of agricultural financing while Istisna is used for financing long-term projects involving capital goods which need manufacturing.

The facts and statistics we discussed, prove the actuality that debt-based modes form a lion’s share of financing mix in IBIs/IFIs around the world. Although, this is also a reality that

Islamic banks and financial entities utilize equity structures like Musharaka and Mudaraba as well but their share in total offerings is very small which is in fact against the Shariah spirit in the context of Islamic finance system. The banking deposit products and various sorts of bank accounts are offered on the basis of Mudaraba and Musharaka while a form of Musharaka called Diminishing Musharaka is also offered to finance transactions involving houses and commodities/assets (Mansoori 2011) etc, but as compared to murabaha-based financing, these transactions are in a meager size. The fact of the matter is that any truly co-operative and well coordinated enterprise must be extensively participatory in nature (Choudhury 2001) and the Islamic banks and IFIs (Islamic finance institutions) need to operate on these lines, in order to be truly “Islamic” and “Shariah-complaint” in their dealings and transactions. Islamic banking lags behind in the process of research and new-product development when it comes to the area of equity-financing tools and techniques like Sukuk, Mudaraba and most importantly Musharaka. Now we will review product development in Islamic banking and financial perspective before making equity-based product propositions and recommendations.

Products Development in Islamic Banking & Finance Context

New product development is a multi stage process that entails defined set of tasks and steps to transform ideas and concepts into feasible and sale-able market products and services. New products are replacing existing products on a regular basis. The rate at which new products are appearing on the market is growing at an exponential rate. (Murthy & Rausand 2008) In modern times, new product development processes are getting more and more sophisticated and intricate, in order to bring innovative and financially viable offerings into the market to eventually grab the competitive advantage form the other players in the industry. Product development is an important area in which Islamic banking and financial institutions should focus their resources. (Jalil & Muda 2007) The new product development in Islamic banks must always be under the keen supervision of Shariah advisor to ensure Shariah compliant product development processes and operations. (Meezan Shariah Advisors Report 2013) According to Jaleel & Muda (2007), main Shariah issues with regards to Islamic financial product development are four: first is heavy reliance on the fixed mode of Islamic concepts – the same finding as we discussed earlier in the paper. Second is the underutilization on Islamic Partnership concepts, the same fact on which this research is based, thirdly the practice of legal device called hilah or legal stratagems, and fourthly harmonization of opinions of various stakeholders and schools of thought. Ahmed (2011 b) suggested that Islamic banks must strategize their product development processes to compete effectively with conventional/interest-based banks. Ahmed (2014) concluded that, Shari’ah department and SSB (Shariah supervisory board) play a vital role in ensuring ‘Islamic’ nature of Islamic banks by fulfilling the Shari’ah requirements in product development process and the procedures afterwards.

Equity – Based Product Development & Propositions

This is unfortunately a glaring fact that Islamic banking and financial institutions mainly offer products and services that are largely debt-based. As discussed in our analysis of Islamic banking product assortment section, a major share of financing and product mix of

Islamic banks and financial institutions is based on murabaha and deferred sale models. In countries where Islamic banking is setting standards and benchmarks like Malaysia and some of the Middle eastern countries, Islamic modes of finance including murabaha and tawarruq etc are not only most utilized but also their flawed application gives rise to issues like the lack of compliance levels in accordance with pure Shariah guidelines, negative opinions regarding operations of Islamic banking and financial system and non-fulfillment of Shariah objectives in the broader Islamic economic and financial context. When we discuss equity based products, Musharaka is a primary concept to consider in this regard. Any venture or business undertaken by two or more people can be termed as a Musharaka. To be more specific, Musharaka refers to a form of business partnership wherein two or more than two parties/persons share profits at a mutually agreed ratio and share losses in proportion to their investment. Musharaka is derived from the root word Shirka/Sharika which means being a partner. According to Rammal (2004), Musharaka is not as popular as other Islamic financial instruments, Musharaka is still deemed to be one of the most authentic forms of Shariah compliant financing. As discussed earlier, Musharaka is originally a Shariah-complaint contract but to make sure this contract does not exceed the boundary of the Shariah and does not get assimilated with the interest based contracts, some conditions set by the scholar of Islamic commercial law need to be followed. (Al-Kawamelah, 2008; International Fiqh Academy, 2004) These conditions relate to various aspects like capital, profit sharing mechanism, business operations, rights and obligations of partners, and termination. Now we will discuss the significance of Musharaka by looking at its cotemporary usage in the modern Islamic banking and finance context. (Aqib Ali 2016) Another reason of not employing and utilizing Musharaka-based financing is that the Islamic banks, in a mixed banking system, as well as investment companies need to offer relatively less risky modes of financing as compared to Mudaraba or Musharaka in the wake of severe competition from conventional banks and other financial institutions. (Ibrahim & Khalifa 2011) Musharaka is an equity-based and participatory technique in Islamic financial framework. But unfortunately the product assortment of Islamic banks which represent the majority of Islamic Financial Institutions (IFIs) (Adel & Mustafa 2013), is dominated by debt-based financing mechanisms i.e. financing modes that involve debt-repayment like Murabaha and Ijarah etc.

By employing equity-based financing tools like Musharaka and Mudaraba, Islamic banks may enhance the goodwill of Islamic banking paradigm and improve the overall level of Shariah compliance in their offerings. Mudaraba and Musharaka structures and the derived finance models that is fully in line with the principles of Shariah and follows the Shariah guidelines in true spirit, this makes Musharaka, a truly Shariah compliant financial tool. The other major concept in equity-based finance is Mudaraba. Mudaraba is a form of business partnership in which two or more persons join hands to conduct a business and share the profits in a mutually agreed ratio. The factor that makes a Mudaraba different from other forms of business partnerships is that only one party invests capital while the other operates and manages the business without any investment or capital contribution. Mudaraba is an Islamic and Shariah-compliant method which closely resembles the modern finance offerings provided by the venture capital and private equity firms. Mudaraba is a versatile tool which may facilitate business and trade in multifaceted ways. From international trade to project finance and from long-term business partnerships to short-term working capital finance, Mudaraba is an effective solution which can aptly fulfill the requirements of the parties concerned in a Shariah-complaint manner. Mudaraba is a most suitable alternative of interest-based financing mechanisms for parties on both sides i.e. the ones who need funds and the ones who have surplus funds.

Shariah conformity is not the only benefit of Mudaraba and Musharaka structures, but it is the versatility and diverse nature of these concepts that makes them, suitable for any kind of banking and finance transactions, from long-term financing to short-term funding, from project finance to working-capital finance, from corporate to consumer finance transactions, both Mudaraba and Musharaka offer solutions for almost all the contemporary finance dealings. Apart from these being used directly, these equity-based models can also be used to construct and issue Sukuk like Mudaraba (Saeed & Salah 2014) for the corporate entities and government. Now we will discuss the proposed application of equity-based mechanisms and their brief modus-operandi, keeping in context, the contemporary financial transactions, in the following broad categories:

Working Capital & SMEs: Working capital needs such as purchase of raw material for manufacturing concerns can be facilitated through Musharaka. Apart from this; trade finance, SMEs (small and medium enterprises) financing and current assets funding, all can be done using Musharaka or Mudaraba models. For such instances, various Musharaka variants like Shrikat-al-Milk, Demining Musharaka etc may be adopted.

Venture Capital & Corporate Finance: Musharaka can be used for project finance based on equity participation by the fund-giver and sharing the returns once the project starts generating revenue. The project financing is similar to contemporary venture capital arrangements whereby the risk taker lends funds and shares the profits for taking equity-stake. Apart from this Mudaraba can also be used in this case wherein the Rab-al-Maal is fund-giver and Mudarib is the one requiring funds, they can decide the contracts terms mutually based on Islamic/Shariah guidelines. Especially, for corporate entities requiring large amounts of funds, Musharaka as a long-term financing tool can be easily employed. Profit ratios and sharing mechanism, be decided at the transaction’s beginning while losses can be adjusted in proportion to investment contribution.

Foreign Trade & Import/Export Financing: Musharaka can also be used to finance imports & exports for the benefit of the industry. Opening of LCs (letters of credit), trading of assets, materials and inventories at global scales among cross-border parties can take place through Musharaka basis. This can be executed by applying Diminishing Musharaka in which case the Islamic bank or IFI would take possession of assets and/or commodities and would transfer their ownership gradually by selling-out its share to the other partner i.e. the client from whom the Islamic finance/banking institution bought the goods/assets at the outset of the transaction.

Consumer & Personal Finance: Financing for consumer durables can be offered on the basis of Musharaka. It can also be used for financing purchase of houses or construction material for building a house. Usually in cases like these banks use a Musharaka variant called Diminishing Musharaka. The equivalent of Diminishing Musharaka is Musharakah Mutanaqisah which is employed in Malaysia.

Unfortunately Musharaka and Mudaraba, being such vibrant structures fail to find their due share in the product mix of Islamic banking and financial institutions around the world yet this is encouraging that the stakeholder including the Islamic finance practitioners and bankers realize that over-reliance in debt-based mechanisms is not a very good omen for Islamic finance system and it is imperative to shift focus from modes like murabaha, inah, and salam etc to more equity-based product models by adopting offerings based on Musharaka and Mudaraba mechanisms.

Conclusion

As discussed, this is a glaring reality that Islamic finance paradigm is seemingly being hijacked by debt-based finance products and it is need of the hour to accelerate the process of new product development by facilitating innovation and creativity in the area of equity-based financing in order to develop products and offerings that are not only financially viable and competitive but also are more Shariah-compliant and "Islamic" in true sense. Diverting the attention from debt to equity finance structures by proposing various applications of participatory modes of Islamic finance based on Islamic partnership models of Mudaraba and Musharaka, the research study endeavors to enhance the perceptions and image of Islamic finance paradigm and attempts to make a favorable contribution in the field of Islamic finance by urging the Islamic banking practitioners to address this critical issue.

Based on the analysis of Islamic banking and financial institutions' products assortment, we can clearly draw a conclusion that modes of finance which resemble the conventional product structures in their operations and procedures are being extensively adopted by Islamic finance institutions. The chief tool or technique utilized by them is Murabaha. Both the statistics and field practices ratify this finding that murabaha dominates the product and financing mix of Islamic banks globally. Apart from murabaha and ijarah, other Islamic finance products that are also debt-based but still used by Islamic banks are Salam, Tawarruq, and Istisna etc. Islamic finance stakeholders especially the Shariah scholars and Islamic bankers and practitioners need to gear up for a promising future of Islamic finance paradigm by inventing, promoting and implementing participatory and equity-based financial models by devising mechanisms that aptly suit and are able to cater to the contemporary financial truncation requirements. This would not only warrant a positive change in the overall outlook of Islamic finance initiative but would also prove to be a landmark achievement in obtaining greater degree of Shariah compliance in Islamic finance products which will eventually contribute towards the attainment of ultimate objectives (maqasid) of Shariah.

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