Shari’ah directives on nature of partnership capital: possible economic implications

Introduction

The financial crisis that engulfed the whole world, severely affecting the economies of a large number of nations, has 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 ultimate crisis 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 availability 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 century. In the aftermath of the recent financial crisis, it would be prudent to review the relevance of these regulations.

Although the topics demands a broader approach, for reasons of brevity, the scope of the current paper is limited to the nature of the capital in equity relationships created by Islamic banks with clients based on mushārakah or mudārabah, where they appear to be of especial relevance. In observing the practical scenario involving some forms of equity finance practised by Islamic banks, implementation of these aspects raises questions. It is seen that in many instances, release of the funds 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.

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, and to examine the extent to which this is reflected in the practice of Islamic 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 sharīʿah directive.

Existence and presence of capital in Islamic legal texts

Schools of Islamic law agree on the fundamental issue that the capital in shirkah al-māl, i.e. capital based partnerships, should necessarily be existent and available for the validity of the contract, although there is 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 Shāfiʿi school is noted for the stress it places on this aspect, more than others. Shāfiʿi jurists deem the occurrence of a foregoing shirkah al-milk essential for the formation of a valid shirkah al-ʿaqd. As such, the presence of jointly owned capital is imperative for shirkah al-māl. 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 mushārakah. 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.[1] This follows the position maintained by Shāfiʿiyyah that units of monetary currency are distinct entities, where particularization (*taʿyīn*) 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 mushārakah, in the Shāfiʿi school. This appears to be the case even when the capital is *mutaqawwim*, i.e. 'unique' commodities as against generic commodities (*mithliyyāt*). Here, even if the *hīlah* suggested by Shāfiʿi 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 shirkah al-milk, 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 mushārakah. 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 Hanbali law appears similar to the Shāfiʿis in this respect. The Hanbali school, too, does not allow the formation of shirkah 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, as in this event, initiating transactions (*tasarruf*) at once, which is the objective of shirkah, is not possible.[2] Thus, in the view of Hanābilah the contract of shirkah 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 shirkah al-ʿinān.[3]

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[1] See al-Ramlī, *Nihāyah al-Muhtāj*, vol. 5, p. 7.

[2] Ibn Qudāmah, *al-Mughnī*, vol. 5, p. 127.

[3] Abū al-Hasan al-Mardāwi, *al-Insāf*, Bayrūt, Dar Ihyā al-Turāth al-Arabi, vol. 5, p. 408.

The Māliki school differs somewhat from the above position in that it appears to recognise the possibility of forming a valid mushārakah 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.[4] Therefore, a debt may not become capital in partnership. Availability (*hudūr*) 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.[5] Māliki jurists have thus overlooked the occurrence of a slight delay in the implementation of the shirkah 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.[6] This means that the capital becomes limited to the amount that was available.[7]

The Hanafi school too has insisted on the existence and availability of the capital for the validity of musharakah, however, in a somewhat different manner. According to al-Kāsāni, the capital should be present (*ʿayn*) and available (*hādir*), and may not be a debt or absent property.[8] The Hanafi jurist al-Haskafi states that this ruling is common to partnerships based on both mufāwadah and ʿinān.[9] However, although Hanafi jurists stress on the presence of capital for the legitimacy of mushārakah, they have not insisted that it be available 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 ʿĀbidīn 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.[10] 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 ʿĀbidīn is observed to have given preference to the first. The same is reiterated by al-Kāsāni, 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 in to consideration because the contract of partnership is finalised with purchase.[11] Al-Sarkhasi too stresses that the partners producing the capitals specifically distinguishing it (*taʿyīn*-

[4] Al-Khurashi, *Hāshiyah al-Khurashi*, vol. 6, p. 342.

[5] Ahmad al-Dardīr, *al-Sharh al-Kabīr*, Bayrūt, Dar al-Fikr, vol. 3, p. 350.

[6] Sahnūn ibn Saʿīd, *Al-Mudawwanah al-Kubrā*, Bayrūt, Dār Sādir, vol. 12, p. 62.

[7] A similar position is adopted by Shāfiʿi jurists when part of the capital is withdrawn before commencing operations. See al-Sharbīnī, *Mughnī al-Muhtāj*, vol. 2, p. 432.

[8] al-Kāsānī, *Badāʾiʿ al-Sanāʾiʿ*, vol. 6, p. 96.

[9] ʿAlā al-Dīn al-Haskafi, *al-Durr al-Mukhtār*, printed with *Radd al-Muhtār*, Bayrūt, Darul Fikr, 1979, vol. 4, p. 311.

[10] Ibn ʿĀbidīn, *Radd al-Muhtār*, vol. 4, p. 311.

[11] Al-Kāsānī, *Badāʾiʿ al-Sanāʾiʿ*, vol. 6, p. 96.

particularisation) at the time of contracting or transacting is a condition for the validity of partnership.[12]

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 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 banks

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 mushārakah or mudārabah 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 mudārabah or partial equity participation on mushārakah. At times it could even be an admixture of these two modes, where the outcome would essentially reflect aspects of both mushārakah and mudārabah, 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 mushārakah 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.

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

[12] Abū Bakr al-Sarkhasi, *al-Mabsūt*, Bayrūt, Dar al-Maʿrifah, 1406H, vol. 11, p. 152.

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 mushārakah setup, it involves the issue of existence and presence of capital at the inception of the partnership. In addition, this procedure raises another critical sharīʿah 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 (*majhūl*) at the inception of the contract. To complicate matters further from a sharīʿah 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.

Sharīʿah perspective of debt as capital

As evident, the emphasis placed by the sharīʿah on the existence and availability of capital at the outset of an equity venture naturally precludes the possibility of capital being in the form of a debt. Jurists of different schools of Islamic law have categorically declared the inadmissibility of debt as capital in shirkah.[13] Al-Māwardi 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 shirkah 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.[14] According to the *Majallah*, when two individuals own a debt on a third, a partnership may not be formed with the debt as capital, a position generally upheld in all the schools.[15] 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 (*a'māl*) or goodwill (*wujūh*) 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 mudārabah, to the extent that the consensus of jurists has been recorded on the impermissibility of a creditor converting a debt due to him from another into a mudārabah.[16] As explained by al-Māwardi, the reason for impermissibility is that the contract

[13] Ibn Qudāmah, *al-Mughnī*, vol. 5, p. 127, al-Kāsānī, *Badā'i' al-Sanā'i'*, vol. 6, p. 96.

[14] Al-Māwardi, *al-Hāwi al-Kabīr*, vol. 6, p. 482.

[15] Al-Attāsi, *al-Majallah*, vol. 1, p. 257.

[16] Ibn Qudāmah, *al-Mughnī*, vol. 5, p. 190.

here takes place over absent capital (*māl ghā'ib*). 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.[17] If a creditor wishes to initiate a mudārabah 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 Māliki 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 ribā. They have disallowed the conversion of even a *wadī'ah* (deposit for safekeeping) or a *rahn* (pledge) into capital of mudārabah, due to the same reason. The Shāfiʿi and Hanafi jurists hold this impermissible due to the fact that a debt may not turn into an *amānah*, as is required in the case of mudārabah capital.[18] 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 mudārabah is not a liability on the mudārib, in that he is not required to compensate for its loss under normal circumstances. Jurists other than Mālikiyyah have allowed converting funds deposited as *wadī'ah* into capital of mudārabah, as such deposits continue to be owned by the depositor and remain as *amānah* 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 a mudārabah.[19]

It is clear that the concern expressed by the Māliki jurists appear greatly relevant to conversions of debt into mushārakah / mudārabah 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.

Practice of Islamic banks in converting debt

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 murābahah instalments of various types, ijārah rentals, and even *qard hasan*. 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

[17] Al-Māwardi, *al-Hāwi al-Kabīr*, vol. 7, p. 309.

[18] Ibn Rushd al-Qurtubi, *Bidāyah al-Mujtahid*, vol. 2, p. 257, al-Khurashi, *Hāshiyah al-Khurashi*, vol. 7, p. 148. It appears from the reason stated by the Mālikiyyah that a reason for the prohibition is blocking of avenues (*sadd al-dharā'iʿ*) which is a recognised principle according to them.

[19] Ibn Qudāmah, *al-Mughnī*, vol. 5, p. 191.

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 clause (*iltizām*), as sanctioned by a number of sharīʿah boards as well as the AAOIFI Sharīʿa standards, could only be channelled towards charitable avenues.[20] 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 sharīʿah.[21] 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 mushārakah / mudārabah 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 mushārakah / mudārabah 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 sharʿīah aspects of concern such as the transformed significance of the collateral obtained initially to secure the debt.

The dictate of the ruling that the 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 mushārakah, 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 Shāfiʿi 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

[20] AAOIFI, *Shari'a Standards* May 2002, p. 39.

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

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 mushārakah 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 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.

Modus operandi of Islamic banks in assigning capital

Having laid down the position the schools of Islamic law uphold on the issue, we could now examine the routine modus operandi as found in the practice of Islamic banks in this regard. As described earlier, in financing relatively longer-term mushārakahs, 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 mushārakah, 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 mushārakah 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 murābahah and ijārah, in addition to the mushārakah. 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.

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 mushārakah agreement, the usual procedure employed by

conventional banks is followed, with the mushārakah 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 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 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 Islamic 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 shirkah / mudārabah, different from other modes. After recognising the validity of such an arrangement in joint investment accounts, it has been apparently extended to include mushārakahs 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.

Standpoint on existence of capital in modern fatāwa

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. Sharīʿa Standards published by the Accounting and Auditing Organization for Islamic Financial Institutions (hereafter referred to as AAOIFI Sharīʿa Standards), in describing the basis for sharīʿah rulings on sharika, 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.[22] 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 mushāraka financing that the mushāraka 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.[23] 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.[24]

Sharīʿah boards of Islamic banks are not generally observed to have addressed this issue in detail. A ruling issued by the Sharīʿah Board of Kuwait Finance House has emphasised on the existence of capital enabling immediate investment in shirkah al-māl, and has underscored that the shares of both parties should be in this form.[25] Another fatwā 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 (*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.[26] 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 above, 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.

Tracing the roots of the apparent inconsistency

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

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[22] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), *Shari'a Standards* Safar 1423H – May 2002, Bahrain, pp. 219, 202.

[23] AAOIFI, *Accounting, Auditing and Governance Standards for Islamic Financial Institutions* Safar1423H – April 2002, Bahrain, p. 185.

[24] AAOIFI, Accounting Standards April 2002, pp. 168, 169.

[25] Sharīʿah Board of the Kuwait Finance House, *al-Fatāwa al-Sharʿiyyah fī al-Masā'il al-iqtisādiyyah*, vol. 1, p. 320.

[26] Sharīʿah Board of the Kuwait Finance House, *al-Fatāwa al-Sharʿiyyah fī al-Masā'il al-iqtisādiyyah*, Kuwait, Kuwait Finance House, 1989, vol. 1, p. 336, 338.

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 sharīʿah basis for this inference is not clear, unless if each operation is considered as an individual mushārakah.

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. As shown above, 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.[27] 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.[28] 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,

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

[28] 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 Waqar Masood Khan, *Transition to a Riba Free Economy*, Islamabad, International Institute of Islamic Thought, 2002.

and have broadened the definition of money.[29] 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.[30] 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.[31] Credit is an invaluable supplement to money today.[32]

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.[33] 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.[34] The general outcome of this process could be observed to be an unnatural expansion of money supply, a major cause of inflation.[35] 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, Islamic banks too subscribe to the process of credit creation.[36]

In the context of these altered conditions affecting money and monetary value, ensuring the presence of a stock of money forming the capital of mushārakah 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, not feasible within the

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[29] 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.

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

[31] Ingham above, p. 56.

[32] *Microsoft Encarta Encyclopedia* 2003, optical disk, Microsoft Corporation, "money."

[33] Ingham above, p. 27.

[34] Ingham above, p. 38.

[35] 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.

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

overall nature of the current analysis.[37] Therefore, an investigation as to the impact of this issue is not attempted here, as the current research is limited to verifying the sharīʿah perspective of equity based transactional modes of Islamic banks. However, it could be observed in this regard that the Islamic sharīʿah 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 sharīʿah 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

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 banks in this regard does not appear to reflect the sharīʿah rules adequately.

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 sharīʿah for securing their dues without excessive delay, and may even resort to liquidation of securities where this could be justified.[38] However, turning an established debt into an avenue of income in the above manner appears to be incompatible with the Islamic theory of economics.

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[37] A research on this topic is needed incorporating the sharīʿah angle as well, which could prove to be a timely contribution to the development of Islamic banking and finance.

[38] For a list of measures that could be adopted for overcoming the problem of default in debt settlement in conformity with the Sharīʿah in contemporary commerce and finance, see *AAOIFI Shariʿa Standards* May 2002, pp. 28 -76.

There appears a strong possibility that equity financing structures currently adopted could be developed further to ensure a higher level of sharīʽah conformity while curing some of the negative aspects, so that their full potential could be adequately revealed. The nature of the sharīʽah 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 sharīʽah assessment of the altered identity of money and its relationship to debt in the current fiscal environment.

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