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Research Paper

Exploring re-introduction of equity-based ethical modes of business: an Islamic approach

Muhammad Abdurrahman Sadique
[1]*International Islamic University Malaysia, Kuala Lumpur*

ABSTRACT: *Ethical business and commerce modes have suffered an erosion ever since conventional modes based on Western business models had overtaken the fields of banking and commerce. The conventional system of business, sourced from debt based financing with the interest based loan as its primary foundation, does not welcome ethical and mutually rewarding business financing models based on equity. Due to the risk accompanying equity, it has given preference to business financing through lending, for securing interest income without sharing in the risk of the venture in any way. Ethical modes of business and commerce abhor interest, and have kept the door open for wide spread equity participation in business ventures for those interested in financial gain. The current research attempts to consider the modes available for business financing based on equity that conform to the principles of Islamic ethical principles especially, and to analyse the possibility of their application in various situations mainly by Islamic financial institutions.*

KEYWORDS: *ethical, business, equity, financing, Islamic, debt*

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I. INTRODUCTION

With the colonial subjugation of many Asian and African nations during the eighteenth and nineteenth centuries and the early part of the twentieth century, governments based on the Islamic and non-Western systems all but disappeared. The western system of local government and civil institutions was introduced in the colonised countries, which purported to ensure political and economic domination of the colonialists. The ethical principles of Islam, which was the guiding source that permeated all spheres of business and other activities in Muslim communities, became divorced from administration and government. The Islamic legal perspective and rulings pertaining to the day-to-day developments in the commercial and socio-political fields ceased to be searched for and derived. This resulted in the restriction of the application of Islamic principles to dealings at a personal level only. Thus, the progress of the different branches of Islamic jurisprudence that had so far kept abreast with the developments in all human spheres became curtailed at a number of fronts. The literature on the application of ethical standards in the changing conditions and the deriving of the relevant legal rulings started to get falling behind.

The field of business and commercial activity too was no exception. Although the relevant principles continued to be practised at a private and individual level, development of the Islamic commercial system and its large-scale application came to a halt. Incidentally, this was the period when, subsequent to the industrial revolution, hitherto unprecedented changes came about in economic as well as other spheres. As a result, for the first time in history a gap developed between the existent environment of business and commerce and the precepts discussed in the Islamic commercial literature.

Consequently, when Islamic financial institutions came into being in the latter part of the twentieth century, they found the available Islamic literature wanting in respect of contemporary requirements. There was only some material that could be adopted readily. The traditional business modes needed to be adapted to suit the prevalent financial culture. To meet the sudden demand made by these financial institutions, contemporary Islamic scholars came under tremendous pressure to find and develop viable Islamic alternatives to the conventional interest based business products. Based on the trading and financing modes discussed in the traditional works on Islamic jurisprudence, the contemporary scholars have endeavoured to come up with a number of structures that attempt to facilitate trading and financing operations in the modern arena of business and commerce, without violating the recognised Islamic principles. Although what has been achieved so far in this direction is encouraging, much work remains to be done.

II. EQUITY BASED BUSINESS MODES AS THE ETHICAL ALTERNATIVE

The conventional system of business and commerce built on banking revolves around interest based lending. It treats lending and borrowing, resulting in the creation of debt with the obligation of payment of interest on the part of the borrower as the crux of all financial activity. This is a system totally negated by the Islamic canonical sources, which consider involvement in interest based transactions unlawful. The evils of interest oriented debt financing have been analysed by traditional scholars like Imam Al-Ghazzali in his *Ihya* as well as a number of modern economists, but a discussion of the topic falls out of the ambit of the current research. The proposed research plans to focus on the Islamic alternative to the system of debt financing.

The economic and business ideals advocated by Islam as alternatives to debt based modes of financing could be broadly categorised as Qard Hasan and equity financing. Qard Hasan is a loan that entails on the borrower only the repayment of the exact amount borrowed, without the obligation of paying interest or recompensing the lender in any other way. Islam has made extending Qard Hasan a meritorious act of a high order, and this mode of extending loans without expecting any additional return was highly prevalent in Islamic societies, both for consumption purposes as well as commercial purposes, until the rise of the interest based economic theory brought about a change in the outlook regarding money and its time-value. Qard Hasan, as it is not purported to give rise to any materialistic gain either directly or indirectly, is not supposed to play a significant role in business finance today.

Therefore, a large proportion of all business financing in an Islamic economy would of necessity have to be based on **equity financing**, where the financier shares in the profit and loss of the business financed, (Chapra, 1985) Equity financing entails the mutual sharing of risks pertaining to the enterprise among all the participants in equity, and an equitable distribution of the return of the total investment. Due to the fact that all participants contribute towards the formation of the equity of the venture, the profit and loss both are distributed among the participants, which is the distinguishing feature between this mode of financing and the interest based debt financing.

In debt financing, providers of equity on the basis of profit and loss sharing happen to be only the original partners to the venture. Additional financing is injected in the form of a loan at a fixed rate of interest, which comes as a liability on the venture, therefore, does not play any role in increasing the equity base thereby giving stability to the business. On the contrary, it remains a foreign element as far as the assets of the venture are concerned, that does not take a constructive share in enhancing the networth. Therefore, even a large amount of funds injected through loan financing serves only the purpose of inflating the cash position temporarily. Equity financing, on the other hand, does not create passive assets that do not have a real interest in the ultimate performance of the business. It becomes a real player in the business immediately, having a real interest in the profitability of the business, as the returns are directly tied up with the profit/loss outcome of the venture.

In an advanced economy, equity financing should be the rule and not the last resort. Profit sharing provides more flexibility in meeting contingencies. This is because of the balanced distribution of gains as well as the risks among the participants in equity financing, while debt is restrictive and unforgiving, hence less stable. (Othman, 1994) Some analysts have suggested a potential distinction between equity financing and profit sharing in a banking context, on the basis of the difference in the total risk borne by the participants, and the difference in the cost involved. (Iffert, 1989) However, it is evident that in the context of Islamic transactional law, this difference cannot be envisaged, as the partners in equity always share in both the profit and the loss resulting from the venture, and not in the profit only. Therefore, in the Islamic context, equity oriented financing would always entail a proportionate sharing in the risk of the venture, as well as an equitable partaking in the profits resulting from it, in the manner to be fully described in the thesis.

III. CHANNELS OF EQUITY FOR BUSINESS

The channels that equity investment may take in an Islamic society are the same as elsewhere, namely, sole proprietorship, partnership (including both Mudarabah and Musharakah) and joint stock company. (Chapra, 1969) The last, too, may be formulated under the principles of Musharakah and Mudarabah. Joint stock companies, formed according to accepted Islamic norms, could play an important role in the economy, in that they provide an avenue of investment for those who are averse to embark on sole proprietorships or to enter into partnership ventures. Therefore, Equity financing with regard to joint stock companies is separately treated in the proposed thesis.

Sole proprietorship, while being a recognised channel of equity, does not fall within the scope of this discussion except to the extent that a venture started as a sole proprietorship may later resort to equity financing modes by way of Musharakah and thus become joint equity based, even for a short period. As such, the avenues of equity, on the large, are confined to the modes of Musharakah, Mudarabah, and combinations of the two either with each other or with other transactional modes.

A brief introduction of the aforementioned channels of finance in their relation to equity financing by Islamic financial institutions may be appropriate here.

a) Sole proprietorship: The investor in a sole proprietorship initiates and runs his venture on the basis of his own capital. He may resort to any of the many forms of business permitted by Islam for financial gain. In the absence of external infusion of capital, the potential for accelerated growth in this type of venture is limited. However, one may significantly benefit from credit extended by his suppliers and service providers, which in an Islamic setting, will be interest-free. As pointed out earlier, this thesis does not envisage treating the topic of sole proprietorships except as far as they are involved in common pooling of equity for short term or long term financial needs. The Islamic financial institution may play the role of the financier here, by extending funds on an equity partnership basis, either on a Musharakah based relationship or a Mudarabah based one. This would result in the sole proprietorship converting into an equity partnership during the tenor of financing, if not in legal terms, at least in a *de facto* manner. The Islamic aspects of such relationships with sole proprietorship concerns on equity basis would be analysed in the thesis.

b) Partnership: This forms the basis of Islamic equity financing. The basic concepts advanced by the Islam for equity financing could be broadly categorised under Musharakah and Mudarabah, which are partnerships operating on the basis of contributing both equity and fund management, or the contribution of one party being restricted to fund management only. These are developed in to a number of modes, the rules regarding which are comprehensively discussed in the traditional Islamic literature on trade and commerce, albeit against the backdrop of the socio-economic culture prevalent at that time.

In all the variations of Musharakah, profit as well as loss is shared between the participants in the equity according to stipulated rules. The loss pertaining to the capital is borne by the investors in proportion to their equity participation, while profit division could either be on the same basis, or according to some other ratio as clearly agreed on at the outset. In Mudarabah financing, one party to the contract is responsible for the management of the business without contributing towards the equity, hence does not share in the financial loss, while all the equity is injected by the other party, who bears liability for the total loss. Profits are shared based on the agreement between the partners. Mudarabah is a clear illustration of the Islamic alternative to debt financing, in as much as it bears out the principle of investment and service providing on the basis of profit sharing as against risk-free lending at a fixed rate of interest and borrowing under liability.

Islamic financial institutions have adopted these modes to suit the present day financing needs by making various changes in their basic structures. Musharakah and Mudarabah based structures are used today for diverse purposes ranging from import and export to financing large-scale industrial and manufacturing concerns. Different combinations of Musharakah and Mudarabah have been explored by the contemporary Islamic scholars to address the various situations of relevance arising in this type of equity financing by Islamic financial institutions such as short term financing, long term financing, financing of single projects, financing of running business concerns, combination of equity financing with other transactions and financing foreign trade on the basis of equity participation.

c) Joint stock companies: Although a perfect similarity does not exist between the forms of Sharikah and Mudarabah discussed in the classical Islamic legal literature and the modern phenomenon of Joint Stock Company, many latter-day scholars have preferred the position that it could be categorised under Sharikatul ‘Inan mentioned by the classical scholars (Thanvi, n.d.) Once formed, these provide a good avenue of investment for those who are reluctant to venture in to sole proprietorship business or are not eager to participate in partnership ventures, even as a sleeping partner. These offer a large amount of flexibility to investors who are not particularly interested in being shareholders on a permanent basis, as they could invest by purchasing shares and quit the business when required by selling the shares, thus regaining liquidity.

Apart from the above a variety of other channels exist in the form of funds of various types etc., which too technically fall under the two Islamic modes mentioned above in principle.

IV. ISSUES FACED IN IMPLEMENTATION

It cannot be gainsaid that Islamic Finance has been gaining momentum since financial institutions operating on Islamic principles started appearing three decades ago, and the number of Islamic financial institutions at present is said to be around two hundred. These institutions all claim to be providing financial and risk management services in compliance with the accepted principles of the Islamic Shari'ah, though not at the same level. Individual scholars as well as bodies founded by Islamic financial institutions have been able to come up with a range of structures attempting to serve as alternatives to conventional interest-based financing modes. These are being fine-tuned further, based on the experience gained through their practical application by Islamic banks.

As stated above, while negating the interest-oriented system founded on debt financing, Islam has paved the way for an economic system based on equity financing, which would result in the real fruits of ventures being spread out among the society in an equitable manner, while also making all partners to the venture share in the inherent risk pertaining to their ownership. As such, a decisive and unambiguous introduction of genuine equity financing modes in the shortest possible time should have been the goal of the Islamic financial institutions that were founded on the ideal of introducing the true Islamic financial system while providing a compatible alternative to conventional banking to the Muslim masses. However, due to the special constraints under which the Islamic financial institutions had to operate in the formative period, Islamic scholars had allowed them to resort to some trade oriented products which could serve the purpose of providing a Halal alternative to interest-based financing while not diverging drastically from the established practices in the current arena of banking and commerce. When implemented with strict observation of the numerous conditions stipulated, these products enabled the conventional banking modes to be mimicked within a Shari'ah compatible framework in a process that, on the whole, did not diverge much from the prevalent modes of lending and borrowing.

As far as Murabahah is concerned, it is a trading instrument in its original layout as discussed in the traditional literature on Islamic commercial law and has been practised widely for trading purposes. It has been adapted by the Islamic banks for various purposes other than trading, such as debt financing and debt servicing, using a range of stratagems for converting it into a mode suitable for these objectives. Yet, it is of vital importance that in the course of practical implementation of such structures as debt financing tools, due attention is paid to the fact that trading instruments such as Murabahah have their own set of principles, philosophy and conditions, without due observance of which it is not allowed in the Shari'ah to use them as modes of financing. Ignorance of their basic concept and relevant details may lead to confusing Islamic financing techniques with the contemporary system based on interest. (Usmani, 2001)

Several decades after their appearance in the scene of banking and finance, the Islamic financial institutions are observed to be still obsessed with these tools that resemble conventional debt financing products for all intents and purposes, and have not so far been successful in introducing equity financing modes in any effective way. The overwhelming portion of the business of the majority of Islamic banks consists of such debt financing instruments. Implementation of equity financing modes, if at all found, is negligible compared with the extensive Murabahah and Ijarah portfolios. Even in areas where equity financing could be implemented with relative ease, it is found that debt financing is continued to be practised. In the case of the Islamic Developement Bank (IDB), for example, foreign trade financing was on the basis of Murabahah in toto for a long time, although some forms of equity participation have started to be adopted to a limited extent recently. In the twelve years since its inception, the IDB had made available to its member countries a total amount of US$ 5 billion by way of foreign trade operations. (Meenai, 1989)

Due to the persistence of Islamic financial institutions in continuing to use debt financing structures as the main avenue of business, disregarding the fact whether it is justifiable or not, a huge amount of work has been done by contemporary scholars in fine tuning these structures and identifying solutions for difficulties faced in the implementation of these as a universal alternative for all types of interest based loans, so that such financing, although unsuccessful in realising the Islamic economic objectives, remains within the broad limitations of the Shari'ah without exceeding them. In the view of the writer, considering the fact that debt financing is never the ideal Islamic alternative, and as such, could never curb the economic evils of the current system, it is grossly unworthy of the extensive work done by cotemporary scholars in this regard and the ongoing discussion on the topic. It is opined that a major push has to be carried out by academic circles to incline the Islamic financial institutions towards a sincere attempt at floating equity financing products, by increased discussion on the topic and facilitating the way for smooth implementation by finding solutions to the problems lying on the way.

The reasons for the lack of enthusiasm on the part of Islamic banks for an aggressive introduction of equity financing tools in all possible situations, including short term and long term financing of local trade, project financing and in foreign trade, are claimed to be diverse. Of these, a significant objection happens to be regarding the lack of precise and practicable guidelines concerning the correct implementation of Islamic equity financing modes in the above areas. The current research purports to carry forward the work already done in this direction by contemporary scholars, which it is hoped would bring a truly Islamic financial culture in the current day Islamic financial institutions closer to reality.

V. POSSIBLE INPUT FROM PREVIOUS SCHOLARLY WORK

Though a wealth of recently compiled literature abounds regarding aspects of Islamic finance dealing with the economic perspective and the operational and banking perspectives, thorough studies analysing the Islamic aspects with regard to their implementation by Islamic financial institutions in a Shari'ah compatible manner are not many. Although a fare number of works dealing with the theoretical aspects of the modes of equity financing have been compiled, these do not shed much light on the problems arising in the implementation of these structures by the financial institutions, which, too, have a significant effect on the Islamic position of the final outcome. The available studies, too, are mainly in the Arabic language and reflect on the large a mainly theoretical approach.

Thus, the financing and trading modes currently practised by Islamic banks with regard to their Islamic compatibility has to be evaluated, while keeping in view the ground realities. It was observed that the structures adopted as alternatives to interest-based modes used by conventional banks comprise of numerous areas that require careful scrutiny from an Islamic perspective to ensure their admissibility according to Islamic principles, as in the absence of the latter, the transition from interest-based banking to Islamic banking may prove to be an exercise in vain. This was found to be especially true in the case of equity financing structures, which are used by Islamic financial institutions sparingly, and that, too, in a manner that strips them of their natural lustre by adopting various means to make equity financing, too, a faint reproduction of debt financing tools.

The extensive array of traditional Islamic literature presents a full and comprehensive study of trading, finance, and related subjects. It reflects the fruits of the collective Ijtihad of a multitude of scholars, based on the experience gained through application of Islamic principles in diverse Islamic countries, spanning a period of over thousand years. The books of Fiqh and the compilations of Fatawa contain various modes of trading and finance as well as individual structures approved by scholars that can be studied and analysed keeping in view the needs of current financial institutions. Although many of these relate to a trading environment that does not totally resemble the current arena of business and commerce, they may be of immense help in upgrading the modes currently utilised by Islamic banks and developing viable and Islamic compliant structures for application.

As such, further research in this subject would be of use to Islamic financial institutions that have to compete with the well-established interest-based banking and insurance system and are hard pressed to develop a viable scheme compatible with Islamic principles in a relatively short period. Also, erroneous or weak practices gaining acceptance may prove to be harmful for the cause of Islamic finance in the long run, and require to be arrested in time.

VI. PROSPECTS OF INTRODUCING EQUITY BASED MODES

Current Islamic financial institutions use a number of modes of equity financing that have been evolved on the lines of traditionally approved modes such as Musharakah. However, the scope of applicability of these has been extended to include a far wider arena than was purported to be covered by the original modes, sometimes resulting in a mode being applied for a purpose that it was never intended originally to be used for. A number of major combined structures have been formulated using the traditional modes, by fusing together two or more different modes. These structures as researched in to and sanctioned by various individual contemporary scholars and the Shari'ah Boards of different financial institutions are used by Islamic banks in various situations, sometimes by introducing several subtle changes, and at others by juxtaposing with other products.

It is evident that on some occasions, perhaps due to non-availability of precise guidelines, business financing structures are put together haphazardly by Islamic banks for the purpose of meeting a particular situation. Some such structures may have met acceptance among Islamic banks, yet could be deficient with regard to their foundation. Some of the modes that are currently in use have come under criticism, apart from Islamic issues, on aspects such as lack of flexibility and inadaptability for long-term financing requirements.

In many of the Musharakah and Mudarabah variations adopted by Islamic financial institutions for equity financing, the profit loss sharing mechanism has been made dependant on the period of the facility, by ensuring a relation between the profit ratio and the time duration for which the facility is sought. This has been contested as being in contravention to the basic concept of an equitable sharing of profit and loss underlying Musharakah and Mudarabah. The structures adopted for project financing based on these two modes usually incorporate valuation of the input made in the form of assets that give rise to various imbalances that affect the profit loss sharing mechanism. Moreover, Musharakah participation of financial institutions in project financing gives rise to various problems regarding Islamic compatibility in termination of the partnership without liquidating the project. In view of issues such as these, there exists the need for further scrutiny of the partnership structures as practised by Islamic banks. As such, the equity financing modes that are in use could be further reviewed and upgraded in an Islamic as well as a banking perspective, and further light shed on the controversial or problematic areas.

Foreign trade is a field where Islamic modes of financing could be implemented with relative ease. Currently, Islamic banks are employing Murabahah based structures to facilitate foreign trade transactions with a lot of difficulty, as the uncertain nature of foreign exchange make adopting Murabahah a complicated process, at times creating significant doubts in the Islamic compatibility of the transaction, and at others paving the way for hidden and doubtful gains for the financial institution. In many of these situations, adopting equity financing would solve numerous problems from an Islamic perspective, apart from bringing the transaction closer to justice and fair play. Hence, equity financing modes for utilisation in the area of foreign trade could be fine tuned and Islamic difficulties solved.

Investment and savings accounts offered by the Islamic financial institutions are claimed to function mostly on the basis of Mudarabah, where the depositors enter in to a contract of investment with the bank for sharing the profits realised by utilising the deposited funds in advancements to business ventures based on various structures. The popular method employed by most of the Islamic banks for profit distribution among depositors is the 'daily product' method, where the profit is calculated on the basis of both the amounts that had remained in the account and the respective number of days. This has been contested on valid grounds by some contemporary Islamic scholars, and possibility exists for developing alternative structures without compromising well-recognised principles.

VII. CONCLUSION

The reality of the current Islamic financial scene is that a number of business modes that have been adapted by Islamic banks for financing purposes are purported to be trading modes in their original layout, that have little in common with investment and financing. These modes are not the perfect Islamic substitutes for the interest based financing modes they are supposed to replace, but are extensions of debt financing products, that have been adapted to conform to some Islamic legal requirements. Continued operation of these could not be expected to realise the fruits of the ideal Islamic economic system such as an equitable distribution of wealth and a financial culture free of oppression, monopoly and hoarding of wealth, which could only be achieved through full-fledged implementation of the Islamic modes of equity financing.

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