DECREASING PARTNERSHIP (*AL-MUSHĀRAKAH AL-MUTANĀQIÎAH*) FOR ASSET AND VENTURE FINANCING: REALIZING SHARI‘AH ESSENTIALS

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Abstract

Al-mushārakah al-mutanāqiÎah or decreasing equity partnership based modes could be used for financing asset procurement as well as projects in a variety of situations. The shari‘ah admissibility of this mode essentially depends on the reality and independent functioning of the various contracts. Diverse capacities the parties undertake through the component contracts should be effectively reflected, especially through fulfilling the duties pertaining to ownership and lease, and accepting the liabilities involved. Gaining legal recognition for the component contracts should be attempted for. In decreasing partnership for ventures, the equity structure should not be based on terms favourable to one party alone. Replacing the legally binding promise to purchase with an understanding to that effect, giving the partners a choice in the matter, could be more conducive towards the equity relationship.

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Introduction

In financing asset procurement as well as ventures under Islamic banking structures, there are a number of areas where equity financing modes could be employed with distinct advantage. Although projects that do not generate income are not the primary subjects for equity-based financing modes, the semi-equity based mode of *al-mushārakah al-mutanāqiÎah* or decreasing partnership as proposed by contemporary scholars can be used where such portfolios involve procuring assets. Here, equity participation takes place in the ownership of the asset, whereby the project may gain stability until reaching a stage where it may run independently. The gain to the financier in such projects may realise in an alternative manner such as sale or lease of his share to the client partner. Thus, such portfolios are financed through structures based on decreasing partnership for asset purchase. Examples could be the establishment of office complexes, houses and buildings for utility purposes, public welfare projects such as parks, land and vehicles for use etc.

Equity modes could be effectively used in ventures that are expected to generate income either in a short period or on a long-term basis.[1] Here, financing could take the forms of *mushārakah* and *muÌārabah*, through which the bank may positively contribute to the venture against a share in profits realised. In addition to such full-fledged equity modes, when circumstances demand, the decreasing partnership mode too could be used for financing ventures, especially when the financier does not desire prolonged involvement in the project. Where appropriate, from small and medium scale ventures, even larger ventures that are relatively long-term such as projects involving production and manufacture could be financed based on decreasing partnership.

The current paper discusses the primarily equity based mode of *al-mushārakah al-mutanāqiÎah*, popularly referred to as decreasing partnership or diminishing partnership, and attempts to shed light on some of the important shari‘ah aspects frequently overlooked in the implementation of this structure in a banking context.[2] Some of the essential features of this

[1] Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, Karachi: Idaratul Ma'arif, 2000, 56, 61.

[2] For a discussion of some other aspects also relevant to micro and medium-sized projects, see the author's paper titled "Financing MMEs through Decreasing Partnership" in Mohammed Obaidullah (Ed.), *Islamic Finance for Micro and Medium Enterprises*, Jeddah: IRTI, IDB, 2008, 53-73.

mode are analysed here in brief, although the inclusion of multifarious contracts such as sale, lease and agency in the structure would demand a more detailed evaluation.

Decreasing partnership – *mushārakah mutanāqiÎah*

The forms proposed by contemporary scholars under the name of *al-mushārakah al-mutanāqiÎah* or *al-mushārakah al-tanāzuliyyah*, also referred to by the names of *al-mushārakah al-muntahiyah bi-al-tamlīk*, i.e. partnership ending in transfer of ownership, and *al-mushārakah al-mutanāqiÎah wa al-muntahiyah bi-al-tamlīk*[3] are various, all of which share in the formation of an equity relationship at the outset, over tangible assets or in a joint venture. The major varieties proposed or are in practice could be delineated as follows.

The structure for facilitating acquirement of assets usually functions through an initial joint purchase of an asset, where the undivided share of the bank is leased on *ijārah* to the client. Based on a prior promise to the effect, the client continues to purchase the share of the financier in equal units, leading to the gradual decrease of the bank's stake in the asset. The bank, based on an undertaking offered that is unrelated to the *ijarah* contract, decreases the rental in accordance with its decreasing share in ownership. With the purchase of all of the bank's share, the whole asset is finally owned by the client, resulting in the financier's complete exit. In a variation of decreasing partnership advocated for joint ventures, the purchase of the share of the financier, i.e. the bank, is prescribed to commence after the venture had started to function in a steady manner and the objective of the venture had been achieved, e.g. the establishment of a functioning supermarket. Each partner is given total freedom to sell his share in portions to the other, or to a third party. In another variation recommended for joint ventures, a portion of the profit or net return through the project remaining after the client and the bank had claimed a part of the profits at each profit loss calculation is set aside for the purchase of the share of the bank. Thus, the net return is divided into three portions in this model, where a portion is allocated for the ultimate secession of the bank from the venture.[4] A variation of the same structure suggests that after the bank had secured its share of profit at each profit distribution, the remaining portion

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[3] First Islamic Banking Conference Dubai, 22-24 May 1979, held at Dubai Islamic Bank, *Fatāwā Sharʿiyyah fī al-Aʿmāl al-MaÎrafiyyah*, 21.

[4] MuÍsin AÍmad al-Khudayri, *al-Bunūk al-Islāmiyyah*, al-Qāhirah, Iytrak li al-Nashr, 1995, 133.

be retained for the purchase of the bank's share within a stipulated duration.[5] A third structure for joint ventures proposes that the total value of the project be split into equal units, which are acquired by the bank and the client partner proportionate to their investments. The profit of the venture would be divided as agreed between them. The client would be allowed to purchase any number of units from the bank's share whenever he could afford the liquidity to do so without adhering to a fixed schedule, until he becomes the sole proprietor of the venture.[6]

Based on these variations, definitions proposed to decreasing partnership have also differed. AAOIFI Shari'a standards, which apparently upholds the mode as a form of contractual partnership, has described diminishing *mushāraka* as a form of partnership in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to him.[7] In a similar vein, AAOIFI Accounting Standards defines it as a *mushāraka* in which the Islamic bank agrees to transfer gradually to the other partner its (the Islamic bank's) share in the *mushāraka*, so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture.[8] Some have defined this structure as an agreement between two parties for creating a *shirkah al-milk* between them in a commercial venture, property, industrial factory etc, so that it concludes with the total transfer of the share of one partner to the other in stages through independent contracts of sale that take place successively.[9]

Decreasing Partnership for asset purchase

When decreasing partnership is applied in projects that involve the procurement or development of assets, the mechanism[10] envisages the joint purchase of an asset by the Islamic bank and the client initially. A variation where the bank effects the initial purchase alone, i.e. without the

[5] Abd al-Sattār Abū Ghuddah, "al-Mushārakāt al-Mutanāqisah wa Dawābituhā al-Sharʿiyyah", in *al-Iqtisād al-Islāmi*, No. 277, Rabīʿ al-Akhir 1425H, vol. 24, p. 217.

[6] First Islamic Banking Conference Dubai, 22-24 May 1979, held at Dubai Islamic Bank, *Fatāwā Sharʿiyyah fī al-Aʿmāl al-MaÎrafiyyah*, 22.

[7] AAOIFI, *Shari'a Standards* May 2002, 214.

[8] AAOIFI, *Accounting Standards* April 2002, 189.

[9] NazīÍ ×ammād, "al-Mushārakah al-MutanāqiÎah wa suwaruhā", *Majallah Majmaʿ al-Fiqh al-Islāmi*, 13th Session 2001, vol. 2, 513.

[10] See Muhammad Taqi Usmani, 82.

involvement of the client, the equity basis starting after the client purchases a portion of the asset subsequently, does not seem to have found support. The operational steps commonly involved in the above process could be outlined as follows:[11]

Credit evaluation of the client, where the credit risk involved in the project would be scrutinised, followed by the approval of the facility takes place first. This is because, in spite of the project being founded on an equity basis, the selection of the asset and carrying out its purchase is usually handled entirely by the client, the involvement of the bank in the process being limited to the extension of funds. As such, it is vital to verify the genuineness of the proposal and the nature of the outcome of the project in the interests of the bank. If the client is unable to purchase the units as agreed, liquidation of the project would involve credit recovery measures, and the possible sale or auctioning of the asset.

Signing an overall agreement follows thereafter, for equity participation in the purchase of the asset. An agency is awarded to the client for effecting the purchase representing both the bank and himself. The promise by the client to purchase the share of the bank in units, usually according to a schedule, the *ijārah* agreement for the lease of the bank's share of the asset to the client, and the unilateral undertaking separately offered by the bank to adjust lease rentals periodically based on its gradually decreasing ownership (i.e. in the event purchases of units by the client take place as envisaged) too are finalised or offered by the respective parties at this stage.

The client purchases the asset using funds released by the bank in the form of a cheque, usually together with his own funds. Customarily, the asset, when involving legal registration as in the case of real estate, is registered in the name of the client / partner. Sometimes, this is done under a clause mentioned on the agency document for purchase, where in addition to purchase, the client is empowered to hold legal title to the property on behalf of both the bank and himself.

If the same asset is offered as security by the client for ensuring due payment of *ijārah* instalments and for securing the bank's exposure towards the purchase of the asset, mortgage of the asset in the name of the bank follows immediately afterwards.[12] Thereafter, the client is free to occupy or utilise the asset for his purposes.

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[11] Abū Ghuddah above.

[12] The bank safeguards its interests by holding title deeds and registering a charge. Mohammed Obaidullah, *Islamic Financial Services*, 63.

The client pays the agreed price for a unit together with the *ijārah* rental for the portion owned by the bank, at the end of the designated interval. The sale of the unit is required to be finalised through an offer/ acceptance process. Although the *ijārah* rental is arranged usually to fall due every month, purchase of a unit could take place at intervals longer than a month, as agreed.

At the end of the period, when all units have been purchased by the client duly, the mortgage is annulled, and the asset becomes completely owned by the client, free of encumbrances. If the client had not purchased some of the units, in this instance the *ijārah* will be extended for another period, based on a rental to be decided at that time, or according to guidelines stipulated in the initial agreement.

As far as the legal framework for decreasing partnership in the context of Malaysia is concerned, the relevant regulations including the Islamic Banking Act 1983 and the Guidelines on Skim Perbankan Tanpa Faedah (Interest-free Scheme) 1993 do not explicitly refer to an individual mode by the name of decreasing partnership or *mushārakah mutanāqiÎah*. Despite this, the legal aspects of this arrangement could be ascertained through considering the component contracts of sale, lease, and partnership, which find reference in the guidelines. The bank's joint purchase of an asset with the client, followed by its sale to the latter in units, is evidently admissible, as trading is allowed for Islamic banks. Similarly, the bank initiating a joint venture with the client on the basis of *Al-Musyarakah* is provided in the guidelines.[13] An Islamic bank may also lease equipment, buildings etc to a customer at an agreed rental.[14]

With regard to the bank's joint purchase of the asset and its sale to the client in uints, when the asset in question is such where its sale involves stamp duty or Real Property Gains Tax (RPGT), this could necessitate payment of stamp duty for the complete sale price to the client and RPGT for the bank's profit margin, under Stamp Act 1949 and RPGT Act 1976 respectively. However, based on subsequent amendments to these Acts intended to facilitate Islamic modes of financing, stamp duty is chargeable only on the original amount financed, and the gains of an Islamic bank through the transaction are exempted from tax. In addition, the Income Tax Act 1967 was amended to allow customers of Islamic banks to enjoy benefits enjoyed by customers

[13] Guidelines on Skim Perbankan Tanpa Faedah (Interest-free Scheme) (1993) Pt II s 3 and Pt V s 3.

[14] Guidelines on Skim Perbankan Tanpa Faedah (Interest-free Scheme) (1993) Pt II s 8 and Pt V s 4.

of conventional banks on interest payments.[15] All these concessions should evidently be applicable also in the case of facilities based on decreasing partnership.

Some shari'ah issues relevant to decreasing partnership

Amalgamation of different contracts together

As in the case of many of the modern Islamic banking products, a vital question that becomes relevant here pertains to the shari'ah acceptability of amalgamating various contracts together in a single process with the connivance of the contracting parties. This aspect, i.e. such pre-agreed blending of contracts of diverse forms in a variety of orders and formats, which is not limited to decreasing partnership, is found to permeate modern Islamic banking products as a whole. An example could be *murābaÍah*, where the original contract involving the sale of an asset through a transparent pricing technique, is coupled with additional features such as a previous order placed by the potential buyer of the asset, an agency to the same party for purchasing and taking possession of the asset on behalf of the bank, a binding promise made by him to purchase the asset from the bank etc. Since a proper treatment of the topic would involve a discussion of fundamental factors that call for such amalgamation in the operation of Islamic banks, its shari'ah validity in the context of different transactional modes, measures taken for eliminating adverse aspects that arise through such amalgamation etc. that are not limited to decreasing partnership alone, an analysis of the issue is not attempted in the course of the current discussion. However, we may briefly state below the position adopted by the critics, and the explanation provided by contemporary scholars validating such amalgamation when the shari'ah guidelines are observed.

Critics regard that at best, the combination of such components into one transaction weakens the integrity of the contractual principles involved, and at worst represents a blatant technique for bypassing the Islamic prohibition of usury.[16] A major apprehension on the part of critics seems to be that in a banking environment dominated by the conventional banking establishment and permeated with notions of profit inalienably tainted with theories of interest,

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[15] A new s 14A was added to the Stamp Act 1949, while the schedule 2 was amended and a new paragraph 3(g) introduced in the RPGT Act 1976. A new s 2(7) was inserted in the Income Tax Act 1967. See Nik Norzrul Thani (et al.). *Law and Practice of Islamic Banking & Finance*. Kuala Lumpur: Sweet & Maxwell Asia, 2003, 94-96.

[16] Tarek El Diwany, "Travelling the wrong road patiently," in *Banker Middle East*, Sep. 2003, <http://www.islamic-finance.com>

such structures could provide Islamic banks with a convenient excuse and means for practising interest based financing under an Islamic nomenclature. This fear is augmented due to the fact that some transactions such as sales and leases carried out by Islamic banks are based on non-legal documents, due to which the consequent relationship between the bank and the client tends to fall short of legal recognition. Islamic banks do seem to affirm that such private documents are held by them to represent real transactions and that they consider themselves bound by the ensuing transactional obligations. Despite this, some reluctance noted on the part of Islamic banks in discharging duties pertaining to ownership and bearing liability, and some operational aspects such as the pricing mechanism adopted etc, are taken by critics to indicate a lack of earnestness with regard to the reality of the transactions. Therefore, the critics' appear to insist that multiple contracts which, with their collective application, lead to an outcome similar to existing interest bearing products, should be discouraged, preference given instead to adopting straightforward and uncomplicated Islamic transactional modes, with the parties playing unambiguous roles while bearing the ensuing responsibilities.

From a shari'ah standpoint, proponents have taken pains to point out that merger of contracts need not always cast a doubt on the validity of the product, unless if the contracts are made inter-conditional in a manner that is not permitted in shari'ah or such amalgamation leads to the overt circumvention of a prohibition or realising a prohibited end. When employed within the necessary limitations and with full regard to relevant shari'ah guidelines, several contracts taking place concurrently or in close sequence alone would not dictate the invalidity of the process as a whole. In many of such situations, since each contract, in a strict shari'ah perspective, would be judged as independent, the perceived amalgamation would be limited to an understanding between the bank and the client to conduct their contractual relationship in a specific manner. Among measures prescribed in this regard for avoiding violation of shari'ah principles where merging contracts is undesirable are, each transaction being concluded through an individual document that does not bear reference to the other contracts, replacing some bilateral contracts with unilateral promises that could be legally binding, careful observance of diverse capacities borne by the parties at different stages as a result of each contract, and treatment of the assets involved with regard to their ownership, rights and liabilities according to the status of such assets in each stage of the procedure. When due observance of such requirements is ensured, any profit realised through the process could not be regarded impermissible. Intentions of parties regarding whether the contracts are held real or not would not adversely affect their outcome, as long as the necessary conditions are fulfilled. Similarly, a prior understanding regarding the contracts that would be entered into in due course by the parties is not objectionable.

Title to the purchased asset

In assets such as real estate and vehicles where registration with the relevant authority is mandatory in many jurisdictions, the legal title to the asset is usually transferred from the original owner, i.e. the housing development firm or the vehicle dealer, to the client directly. Such legal documentation does not involve mention of the bank as a co-purchaser, and registration of the asset in the name of the bank is found to be rare. This is justified as a measure to reduce possible registration and other legal expenses, which could double if the title were to be vested on the bank initially, then to be transferred to the client.[17] Therefore, in documents of legal registration, the client is reflected as the sole owner of the asset. Vehicle purchases, if financed on decreasing partnership, could mention the bank as an owner of a particular category such as absolute owner, a provision usually availed by leasing firms in vehicle financing. Here the ownership of the firm as stated on documents of registration merely reflects its financial interest in the vehicle, which would cease with the successful settlement of the loan or lease / hire-purchase instalments. In the case of real estate, the title deed is made in the name of the client as purchaser, while the bank insists on a mortgage over the property in its favour, so that its financial interests in the asset could be secured in case of default on the part of the client in purchase of the units as promised or payment of lease rentals. Thus, from a conventional legal standpoint, the bank's involvement in the asset is limited to its financial interest, while the ownership rests on the client solely.[18] To smoothen the issue from a shari'ah angle, as mentioned above, the client is appointed as the bank's agent to carry out the purchase of the asset

[17] In the context of Islamic banking in the United Kingdom, double stamp duty has been removed for mortgages etc. Zarir J Cama, "Developing a Comprehensive Islamic Financial System", Asian Islamic Banking and Finance Summit, held 21-22. 09. 2004, at Mandarin Oriental, Kuala Lumpur. In Malaysia, the Stamp Act 1949, the Real Property Gains Tax Act 1976, and the Income Tax Act 1967 have been amended in consideration of the contractual relationship between the Islamic bank and the customer in certain modes of financing.

[18] For general legal considerations influencing development of project financing structures mainly in a Saudi Arabian context see Michael J T McMillan, "Islamic Shari'ah-Compliant Project finance: Collateral Security and Project Finance Structural Case Studies" (May 2001) vol. 48 Fordham International Law Journal.

and to hold its legal title. Therefore, in spite of having the legal title to the asset, the client is considered the owner of only a part of it initially, i.e. to the extent of his participation in the cost of purchase, and would gain complete ownership only at the end of the tenure.

Shari'ah implications of ownership

Through joint purchase, when the bank becomes the co-owner of the asset along with the client, responsibilities pertaining to ownership would necessarily be attached to the bank, proportionate to its ownership.[19] Similarly, a proportionate share of any increase or revenue generated by the asset could be claimed by the bank. The latter aspect is discussed below under decreasing partnership in ventures. Consequently, liabilities pertaining to ownership such as major repairs, risk of loss or destruction etc should be shared by the bank proportionately. These liabilities may not be transferred to the client even though the bank's share is leased to him, because they fall on the lessor even in *ijārah*. Minor repairs and upkeep necessary for usage could be assigned to the client as a lessee is required to bear them. Therefore, in spite of any reference to the bank in the legal documents as a mortgagee, liabilities inherent to ownership would necessarily fall on the bank proportionately.

Due to the fact that decreasing partnership involves co-owning the asset for a relatively long duration, the bank exercising due care in the co-purchase of the asset becomes necessary. Although the client could be made responsible for the selection of the asset, if the latter is unable to provide the usufruct expected, there would be no justification for charging *ijārah* rentals. If the client refuses to purchase the bank's share as a result and the asset has to be liquidated, recovery of the bank's capital outlay may prove difficult unless if additional security is available. Even when the asset fetches a higher price, recovery of rentals may not be justified if the asset had been unusable. Thus, co-purchase dictates that these aspects that are necessary features of ownership and *ijārah* be kept in view at the time.

Legal mortgage over the asset in favour of the bank

The legal mortgage drawn in favour of the bank is construed as a legal measure necessary for securing its financial interests that is not necessarily reflective of the true state pertaining to

[19] For a succinct treatment of Islamic rules on joint ownership of assets, see the authors work *Essentials of Musharkah and Mudarabah: Islamic texts on theory of partnership*, Kuala Lumpur, IIUM Press, 2009.

ownership of the asset. According to this document, the position of the bank is that of a mortgagee who is entitled to monetary dues from the mortgagor. Although not appearing on the deed of mortgage, its applicability is considered limited to the share owned by the client, which is mortgaged in favour of the bank. While this could be valid with regard to the *ijārah* rentals to be paid by the client, its application in demanding the purchase price of units of the bank's share in the asset, from an Islamic perspective, is solely based on the legal enforceability of the promise made by the client to purchase them. Thus, the issue of legal enforceability of promises becomes important in the practical application of decreasing partnership. This is because, if the client defaults in purchasing the share of the bank, the bank would be left with co-owning an asset in which it does not have a long-term interest, and more pertinently, where its claim to part of its ownership is not supported by the title deeds. Therefore, it is necessary that in such an eventuality, the bank be able to compel the client to carry out the purchases as promised. Although the legal enforcement in this case would take the shape of initiating legal proceedings for liquidation of the mortgage, the justification for such a measure would depend on whether the promise made by the client to purchase the bank's share was binding on him. If fulfilment of such promises is held legally obligatory, the bank would have sufficient grounds for attempting to liquidate the mortgage, in order to recover the actual loss suffered due to the client's non-fulfilment of his promise. On the other hand, if standing by such a promise, although encouraged, is not mandatory, the bank may not be permitted to ascribe any loss to the client or to liquidate the mortgage. Thus, it is vital to determine whether the promise made by the client to purchase the bank's share is of a binding nature, where the bank may demand his performance accordingly.

Status of contractual promises

Whether fulfilment of promises could be legally enforced is an issue that has been thoroughly discussed by contemporary scholars especially in the context of Islamic banking transactions. After the rulings on the issue by the former jurists of the schools of Islamic law and others, the topic has been reanalysed in the wake of the legal debate created over the sale of *murābaÍah*. For reasons of brevity, this issue is not intended to be re-examined under this research. It suffices to state here that in the context of the promise a client is usually required to make in applying for a *murābaÍah* from an Islamic bank that, subsequent to the bank's purchase of the asset required by the client, the latter would purchase it from the bank on *murābaÍah* terms, a number of contemporary scholars have upheld the verdict of some Māliki jurists that evidently recognises the enforceability of promises in such circumstances.[20] According to them, although promises are not binding generally, if the promisor had caused the promisee to incur some expense or undertake some labour or liability on the basis of the promise, it is mandatory on him to fulfil his promise for which he may be compelled by the courts.[21] The Islamic Fiqh Academy Jeddah in its ruling on promises relating to *murābaÍah*, after stating that a promise is morally binding on the promisor unless there is a valid excuse, observes that it is legally binding if made conditional upon the fulfilment of an obligation, and the promisee had already incurred expenses on the basis of such a promise. It explains that the binding nature of the promise means that it should be either fulfilled or a compensation be paid for damages caused due to the unjustifiable non-fulfilling of the promise.[22]

In decreasing partnership where the bank's agreement to fund the purchase of the asset on equity partnership basis is directly due to the assurance provided by the client that he would purchase the bank's share subsequently, some contemporary scholars appear to have upheld the above position. Thus, in the event of any reluctance on the part of the client to purchase the units as promised, the bank is justified in demanding his performance. In the event of non-compliance, the bank may recover the actual damages suffered due to the client's failure to fulfil his promise. This could provide the bank with the necessary validation for commencing legal procedures for liquidation of the mortgage. However, it is clear that if the mortgage is liquidated, the bank would be justified only in recovering the actual damages suffered due the client's non-purchasing, together with the *ijārah* rentals for the bank's portion of the asset for the period.

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[20] Abū ʿ Umar Yūsuf ibn ʿ Abdillah Ibn ʿ Abd al-Barr al-Nimri, *al-Tamhīd*, al-Maghrib, Wazārah ʿ Umūm al-Awqāf wa Shu'ūn al-Islāmiyyah, 1387H, vol. 3, 208-209.

[21] See for details, Muhammad Taqi Usmani, "al-Ùuruq al-Mashrūʿ ah li al-Tamwīl al-ʿ Iqārī", in *BuÍūth fī QaÌāyah Fiqhiyyah Muʿ āÎirah*, Karachi, Maktabah Darul Ulūm Karachi, 1415H, 246, 247, and *An Introduction to Islamic Finance*, 120-126, 87-89, Wahbah al-ZuÍayli, *al-Fiqh al-Islāmi wa Adillatuh*, vol. 4, 2928-2930.

[22] Islamic Fiqh Academy, 5th Session held in Kuwait, December 1988, Resolutions Nos. 40-41 (2/5 & 3/5). Enforceability of promises in the context of *murābaÍah* has also been upheld by other bodies such as the Second Conference of Islamic banks held in Kuwait, March 1983.

Liquidation of mortgage in decreasing partnership

In the event of liquidation, from an Islamic perspective, the sale of the asset would signify the sale of a jointly-owned asset to a third party. This could be explained as the bank selling its undivided share in the asset to a third party, together with a forced sale of the share of the client for recovery of the defaulted *ijārah* rentals and any actual loss suffered by the bank due to the client's non-fulfilment of his promise to purchase. In this instance, where the bank's own share is sold to a third party, an actual loss could materialise only when the proceeds through the sale of the bank's share is insufficient to cover the initial costs of purchase and any other relevant expenses, including legal expenses. If the bank's share is sold profitably so that it covers the above, the only amount realisable through the sale of the client's portion is the total of unpaid *ijārah* rentals. Any balance remaining of the sale price of the client's share should necessarily be given to him. This is because of the fact that violation of the promise only gives recourse to claiming actual losses due to such violation. Similarly, it is questionable whether, in assessing actual damages, any charge akin to opportunity cost could be realised. However, since the *ijārah* rentals recoverable usually includes this aspect, it could be ignored.

The sale of an undivided share of an asset to a third party could involve rules of *shuf'ah* or pre-emption according to all schools of Islamic law.[23] However, since the whole property, inclusive of the client's share, would normally be sold in this instance, this factor may not become pertinent, as the client would no longer remain a co-owner after the sale.

In view of the above, transfer of legal title to the property in the name of the client, followed by the bank securing a legal mortgage over the same, does not appear to reflect the underlying transaction of co-purchase in an adequate manner. In the event of liquidation, the latter procedure may not be carried out in a way similar to other mortgages, such as liquidation of security (*rahn*) for recovering an established debt through *murābaÍah* etc.

The long-term alternative would be to attempt to obtain legal recognition for the promises and other transactional documents signed in the course of Islamic banking operations at least to a limited extent, with exemption from duties and other taxes involved in such transactions

[23] According to the majority of schools of Islamic law, the co-owner of an undivided property has the right of preemption. ×anafi jurists have granted this right also to owners of adjacent properties, with conditions. See Ibn Qudāmah, *al-Mughni*, vol. 5, 178, al-Sarkhasi, *al-MabsūÏ*, vol. 14, 91.

normally.[24] This could also result in an increased sense of responsibility in both the bank and the clients in carrying out such transactions. It should not be forgotten that irrespective of whether legal recognition is awarded, all transactions carried out by the bank, when found to fulfil the necessary criteria, are valid and enforceable in shari'ah, and give rise to legal consequences such as transfer of ownership and right to revenue etc.

Independence of contracts

Another issue that is of importance here is whether a binding promise offered by the client for the subsequent purchase of the bank's share could be construed as an instance where two transactions are made conditional to each other. If the promise made by the client is binding and legally enforceable, it could be argued that the co-purchase effected by the bank was carried out on condition that the client's purchase or purchases should necessarily follow as promised. This could come under the famous prohibitions appearing in *Íadīth* of concluding two sales within a single sale or two deals within a single deal, and of a sale accompanied by an unlawful condition[25], that rule out making two different transactions conditional to each other. This being an issue that is of general relevance to all transactions in Islamic law, it is not analysed here at length. However, it has been pointed out by contemporary scholars in this regard that an individual promise that is not related to the text of the contract of sale may not be compared to a condition for the validity of the latter. In the case of a condition related to the contract of sale, the sale would become void if the condition does not materialise. However, with regard to an unrelated promise that is offered separately, the initial contract would remain valid, even if the promise is not fulfilled due to some reason.[26] The fact that the promise is held binding alone would not convert it into a condition of the sale, as it had taken place separately.

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[24] In Malaysia, the Stamp Act 1949, the Real Property Gains Tax Act 1976, and the Income Tax Act 1967 have been amended in consideration of the contractual relationship between the Islamic bank and the customer in certain modes of financing.

[25] The first *Íadith*, reported by Abū Hurayrah (*RaÌ.*) is recorded, among others, by al-Tirmidhi, who classifies it as *Íasan* and *ÎaÎīÎ*, and quotes the statement of Imām al-Shāfiʿ i in this regard which interprets the *Íadīth* to signify a contract of sale where the occurrence of another sale is made a condition for the validity of the former. The *Íadīth* has also been interpreted to mean the sale of an item for a credit price different from its cash price, without resolving either at the time of sale. (*al-Tirmidhi*, *Íadīth* No. 1231, vol. 3, 533) The other two *Íadīth* are reproduced by ʿ Ali ibn Abī Bakr al-Haythami in *Majmaʿ al-Zawā'id* (al-Qāhirah, Dār al-Rayyān li al-Turāth, 1407H, vol. 4, 84).

[26] See Muhammad Taqi Usmāni, 89.

It is due to the above reason that contemporary scholars have emphasised the client's agreement to purchase the bank's share in units should occur in the form of a unilateral promise, that is made separate from the *shirkah* agreement to purchase. The latter document is not expected to carry any mention of the fact that subsequent to the joint purchase, the client would purchase the bank's portion of the asset in segments. Thus, they explain that the two, i.e. the promise and the bank's purchase of the asset in partnership with the client, although taking place with regard to the same asset, are different deals, that are not conditional to each other in a way that would question the validity of the procedure. Therefore, the joint purchase effected by the bank and the client is held to stand valid, despite of the promise offered by the client to purchase the share of the bank subsequently.

The proportionate share of the bank as established through the initial joint purchase is leased by the bank for the expected tenure of partnership. However, although an *ijārah* agreement over a fixed share of the asset at a fixed rental is finalised, due to the planned sale of the bank's share in units to the client, the agreement on the original terms is understood to be effective only up to a short duration, i.e. until the client purchases the first unit. Upon the client's purchase of a unit, the ownership of the bank would diminish, thus leading to a change in the leased asset, which would require amendment of the *ijārah* agreement in addition to adjusting the rental.

In order to avoid the need for multiple *ijārah* agreements each drafted for a specific proportion of the asset and a different rental, the original agreement is made for the whole period, and a separate undertaking to reduce the rental in the event of the client purchasing units of the bank's share is made concurrently by the bank. This undertaking, made unilaterally by the bank without forming part of the *ijārah* agreement or the joint purchase, mentions the reductions in rental that would take place periodically according to the decline in the bank's share, subject to the client's purchase of units. Being separate unrelated transactions carried out individually that are not conditional to each other, these are not understood to impair the validity of the procedure. If this procedure is held valid, it is necessary to observe shari'ah rulings pertaining to lessor / lessee relationship. Thus, although expenses related to minor wear and tear could be assigned to the client, as mentioned above, major repairs and overhauls would necessarily have to be borne by the bank proportionate to its ownership.

Purchase of units by the client

In the course of the decreasing partnership process, the client is expected to purchase the undivided share of the bank in units, usually at pre-agreed intervals. The purchase of each unit would form a separate transaction that should necessarily fulfil the requirements pertaining to sales. Thus, it is emphasised that the sale here take place through a proper offer and acceptance, accurately describing the nature of the unit sold and the price, through which the ownership of the unit would transfer to the client.[27]

It could be argued that in order to simplify the operation of decreasing partnership, the periodical unit purchases could be allowed to take place solely on the basis of payment of the unit price, without the necessity for a contract for the purpose. The purchase here could be understood to take place by way of *mu'āÏāh*, i.e. sale carried out through conduct and mutual exchange, the validity of which is endorsed by the majority of jurists.[28] As the contract of *mu'āÏāh* is effective without the exchange of offer and acceptance, this could suit the purpose. Thus, whenever the client makes a payment towards the facility, or the amount is charged to a current account maintained by him with the bank on the due date, the ownership of the unit could be deemed to have transferred to him.

However, interpreting payment of the unit price itself as a sale on *mu'āÏāh* does not appear satisfactory due to several reasons. If such payment is taken as an instance of *mu'āÏāh*, the validity of the decreasing partnership procedure itself could be jeopardised. This is because, as mentioned above, the legality of the diverse contracts forming decreasing partnership is solely upheld on the basis of the independent execution of each contract. For this purpose, it is essential that the purchase of the units by the client take place as a distinct contract unrelated to the preceding joint purchase of the asset by the bank and the client. This requires that each unit purchase take place in a manner reflective of complete spontaneity, by referring to the nature and description of the unit, the price and other details, without sufficing with any previous understanding. As evident, this could be only accomplished through a proper offer and acceptance. Although this purpose could have been realised through payment and handing over the goods if the sale were to take place on distinct movables, this is not feasible in the sale of

[27] Muhammad Taqi Usmāni, 90.

[28] Ibn Qudāmah, *al-Mughni*, vol. 4, 4, *al-Majallah*, article No. 175, vol. 1, 36, al-Kāsāni, *al-Badā'i'*, vol. 5, 134.

undivided shares of an asset. Therefore, a complete sale transaction comprising offer and acceptance is mandatory for ensuring total independence the contract.

Another vital reason for the necessity of an independent and full-fledged contract is to differentiate the initially made promise to purchase from a contract of future sale (i.e. purchase, in this case). A sale that is made contingent on a future event and is agreed to become effective in the future is not allowed according to many jurists.[29] In the absence of a distinct contract of sale at the purchase of each unit, any payment taking place would be held resultant of the initial promise and its tacit acceptance by the bank, thus evidencing a future sale. It should be noted that payment of the price, being in theory a legal consequence resulting of a contract, is reflective of a contract already having been finalised. In the circumstances peculiar to modern Islamic banking contracts such as *murābaÍah* and decreasing partnership, an asset is purchased by the bank at the bidding of the client, either alone or jointly, with an arrangement supported by a promise to pass on the ownership to the client in the future. In this event, in the absence of a subsequent contract of purchase taking place on clear terms, mere payment of the unit price would immediately relate to the forgoing arrangement. Therefore, for the acceptability of such a procedure, it is necessary a distinct contract of purchase take place subsequently as was promised.

In addition, *muʿāÏāh* as described by jurists involves an exchange of goods against payment clearly depicting the trading intent of the parties, which is held to replace the offer and acceptance. In many of the examples given by jurists depicting *muʿāÏāh*, an offer is seen to be made, although acceptance is absent, which is replaced by delivery of the counter-value (i.e. *ʿiwaÌ* or *badal*) by the relevant party. Where both offer and acceptance are absent, a clear exchange of counter-values necessarily takes place, which substitutes offer and acceptance. It is known that clear reference to the exchange desired by the parties, through citing the form and description of the counter-values and other terms in a manner that leaves no doubt as to their trading intent, is vital for the conclusion of a valid contract of sale.[30] The reason for the acceptability of *muʿāÏāh* despite of the above is that the same purpose is realised in a reasonable

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[29] Abū IsÍāq Ibrāhim ibn ʿ Ali al-Shīrāzi, *al-Muhadhdhab*, Bayrūt, Dār al-Fikr, vol. 1, 266, Al-Nawawi, *al-Majmūʿ*, Bayrūt, Dār al-Fikr, 1996, vol. 9, 321, ibn Qudāmah, *al-Kāfī*, vol. 2, 18, Ibrāhīm ibn Abī al-Yaman, *Lisān al-×ukkām*, al-Qāhirah, al-Bābi al-×alabi, 1973, vol. 1, 264.

[30] Ibn Taymiyyah, *Kutub wa Rasā'il wa Fatāwā ibn Taymiyyah*, vol. 29, 155.

manner through the conduct and action of the parties, that are sufficiently indicative of their intentions. As such, it is obvious that where the conduct of the parties itself is not fully descriptive of the contract, *muʿāÏāh* cannot be considered to have taken place. Therefore, if a contract is to be replaced by a payment by one party, in the absence of physical handing over of the intended goods, reference to the nature of the sale should necessarily be made, thus completing the contract.

The above deals with some theoretical reasons for the unacceptability of *muʿāÏāh* in the situation in question. However, as evident to one familiar with the current setup common to Islamic banks, a primary reason precluding attempts to interpret the payment as *muʿāÏāh* in this instance lies elsewhere. It is that, non-insistence on effecting the unit purchase through a properly executed contract, even if on private papers, would result in the process becoming even further from a valid transaction, thereby lowering it to the level of repayment of capital. Due to the conventional banking notions and culture that are currently observed to dominate the Islamic banking arena, in the absence of legal recognition of transactional documents, the reality of transactions effected by Islamic banks even in writing is a matter of concern. In this situation, forgoing even a private document evidencing the occurrence of a sale may not be regarded as a prudent measure. Observing the process from the client's perspective too strengthens this assertion. Due to the customary perception of banks as lending institutions, all payments arising out of facilities are constantly misunderstood as repayment of loans, which makes the presence of any trading intent implausible. Therefore, it is necessary that a sale take place in this instance in a proper manner through the exchange of offer and acceptance, stating the nature of the segment purchased and the price, so that the reality of the transaction be manifested duly, which could also serve the purpose of rectifying the approach of the client as well as the bank towards the transaction.

Pricing mechanism[31]

The current structure for decreasing partnership as endorsed by a number of contemporary scholars that involves simultaneous operation of diverse contracts such as sale and *ijārah* on an equity platform could be a viable tool in financing asset purchases. Its potential in enhancing the

[31] For a more detailed discussion on issues related to pricing with examples, see the author's paper titled "Financing MMEs through Decreasing Partnership" in Mohammed Obaidullah (Ed.), *Islamic Finance for Micro and Medium Enterprises*, Jeddah: IRTI, IDB, 2008, 53-73.

revenue of Islamic banks and their depositors through the operation of the *ijārah* is a noteworthy feature that differentiates it from fixed price mechanisms such as *murābaÍah*. By means of the *ijārah* contract, a great amount of flexibility could be created in the operation, which, in addition to bringing in additional revenue for the bank in an acceptable manner, could provide the client with more freedom in deciding the duration of the bank's involvement in the asset. However, a constructive application of this aspect would only be possible if the pricing of the unit prices as well as the rentals is done more realistically. Adopting the discounted cash flow technique in a direct fashion for this purpose results in misrepresenting the essence of the structure seriously, while making its application in instances of delay in unit purchase unrealistic.

In order to avoid issues arising out of an apparent neglect of the reality of the different contracts comprising decreasing partnership, unit prices and rentals could be fixed in a manner that is more reflective of the gradual decrease of the bank's share. In addition to a better appreciation of the real nature of the relationship and differentiating the periodical payment from a regular *murābaÍah* instalment, it could enhance the revenue of the bank in the event of delay in purchase of units by the client. This is because the involvement of *ijārah* in the relationship could provide a justification for charging a rental according to the period taken. In facilities such as *murābaÍah*, due to the fact that the asset is sold at a fixed price, default in meeting instalments may not result in any additional revenue for the bank. Any penalty charged based on a previous undertaking by the client to do so should necessarily go to charity.[32] In decreasing partnership, based on the constituent *ijārah* contract, if the purchase of a unit price is delayed even for several months, the rental would be payable unchanged, thus compensating for the delay. However, this could be possible only when the reality of the underlying contracts is effectively highlighted.

Irrespective of the method adopted in pricing, it is imperative that the concept of decreasing partnership be thoroughly understood by the staff concerned as well as the clients, so as to eliminate the possibility of mistaking it as an interest based instrument. Thus, educating the staff as well as clients is highly essential in the initial stages of introducing this mode.

[32] AAOIFI, *Shari'a Standards* May 2002, 39; Muhammad Taqi Usmani, *An Introduction to Islamic Finance*, 131 -137.

Decreasing partnership for financing ventures

The basic ingredients of the decreasing partnership structures advocated by contemporary scholars for financing ventures, for the most part, are found to be similar to those for asset financing. Thus, decreasing partnership here involves joint investment by the bank and the client towards a venture, the share of the bank in which would be later purchased by the client in stages, until the client becomes the sole owner of the project. Although similar in these fundamental ingredients, decreasing partnership for ventures embodies several major differences. Among these is the identity of the partnership, which, as explained before, is based on *shirkah al-ʿaqd*.[33] As a result, rules pertaining to *shirkah al-ʿaqd* would become applicable in such ventures. Division of profits realised through the venture could be agreed to take place on a proportion other than that of ownership, based on the position of the ×anafi and ×anbali schools. However, loss would necessarily be divided on the ratio of ownership. In addition, the share of the bank could be sold to the client at a price negotiated by them at the point of sale, if necessary based on a valuation of the business done by a party chosen mutually. Prior agreement regarding the price of the bank's share or indicating the price payable in a promise to purchase / sell provided by either of them is not admissible, in order to avoid guaranteeing the capital of the other party to that extent.

Within this broad framework, diverse formats have been proposed by contemporary scholars, the major forms of which were mentioned earlier. Through these structures, financing for a large variety of ventures of different types and durations such as housing projects, production ventures, establishment of colleges and hospitals etc is proposed to be facilitated. Although decreasing partnership for ventures involves inception of a partnership for generating income, some scholars have pointed out certain instances where such partnership could be established based on *shirkah al-milk*. These pertain to joint purchase of assets that provide an income such as purchase of buildings, machinery or vehicles for lease or hire. In such instances, decreasing partnership could be based on *shirkah al-milk*.[34] As such, the division of revenue should be on the proportion of ownership. Therefore, when the proportion of ownership

[33] For a discussion of the types of *shirkah* including *shirkah al-ʿaqd* and *shirkah al-milk* and the general theory of partnership in schools of Islamic law, see author's *Essentials of Musharkah and Mudarabah: Islamic texts on theory of partnership*, Kuala Lumpur, IIUM Press, 2009.

[34] Muhammad Taqi Usmani, 90.

becomes altered upon one partner purchasing a part of the other's share, the ratio or profit division too would change accordingly. However, according to the position preferred by some others that all decreasing partnership comes under *shirkah al-ʿaqd*, the partners here could agree on a separate ratio for assigning income that could remain static even in the event of change to the proportion of ownership. The ratio agreed for profit division would vary only in the event of a mutual agreement by the parties to the effect.

Additional operational aspects in financing ventures

The additional operational aspects of relevance involved here could be outlined as follows.

The bank would be required to undertake a thorough feasibility study regarding the venture proposed. Due to the financing taking place in the form of a contractual partnership, the outcome of the venture is of crucial relevance to the bank, in order to recover its capital invested along with a substantial gain. In addition to the prospect of sharing in unlimited high profits due to all profits being divided proportionately, if the venture becomes successful, the bank could expect to earn a sizable profit also through the sale of its share to the client, as the price for such sales would be based on market value. Therefore, assessment of the viability of the venture would demand particular attention of the bank. Being a co-partner who is able to contribute towards the venture, the bank may also consider specialised services it may carry out towards the project, and where worthwhile, hire staff and expertise necessary for the purpose.

The profit sharing ratio for division of final profits would be agreed on at the inception. Contemporary scholars allow the partners to agree on a ratio different from that of capital participation, which could remain static throughout the tenure of partnership or be pre agreed to vary at stipulated intervals, based on the client's purchase of the bank share or otherwise. Along with such agreement, they could arrive at an understanding on the amount of profit that should be set aside from the client's share of profits for purchasing the bank's share in the venture. Either the whole of the client's share of profits would be reserved for the purpose, or a specific portion at every profit division would be agreed to be set aside. AAOIFI Shari'a Standards suggests that the client could promise to set aside a portion of the profit of the return he may earn from the partnership for this purpose.[35]

[35] AAOIFI, *Shari'a Standards* May 2002, 215.

Mobilising the funds and investment will be undertaken jointly by the bank and the client. Where the bank does not have the expertise or capability of undertaking its share of management and other duties, the client may be entrusted with representing the bank in operating the project. However, the bank would be entitled to monitor the progress of the venture as well as taking an active role in auditing financial and other aspects. It may reserve for itself such tasks as receipt of income through the venture and managing the finance. All income through the venture would be credited to the common funds of the venture, and a partner would not be given exclusive rights to any income. Expenses pertaining to the venture would be done from the joint capital, i.e. common funds of the venture, so that a partner is not obliged with bearing them to the exclusion of the other.

After the commencement of the venture, the client could start to purchase the share of the bank in units, based on a price negotiated at that time or professional valuation, as agreed. A price may not be agreed at the inception for this purpose, as it could result in the client guaranteeing the capital of the bank. Thus, the price for the bank's share would depend to a great extent on the performance of the venture at the points of time its units are purchased by the client. As was mentioned earlier, contemporary scholars have suggested various arrangements that could be made in this regard. Purchase of shares could be agreed to commence when the project becomes functional and starts generating revenue. It could be facilitated through profits retained for the purpose.

When all the units of the bank's share have been completely purchased by the client, the bank would cease to be a co-partner in the venture. The client would become the sole owner of the venture, and would be entitled to all revenue generated by the venture. All functions carried out by the bank for the venture will be transferred to the client, and any existent mortgage in favour of the bank will be cancelled at the exit of the bank from the partnership.

Observations on decreasing participation for ventures

Observations made earlier on the decreasing partnership structure for asset purchases would, in a number of instances, be applicable to structures for financing ventures as well. In addition, it could be noted that in decreasing partnership structures for financial ventures as upheld by contemporary scholars, the return that the bank could achieve through its involvement largely depends on the performance of the venture. Except in instances such as where a jointly owned asset is leased to the client, this arrangement does not provide for a definite periodic return to the bank in the form of rentals or otherwise. This is due to the fact that the distributable revenue generated by the venture is directly based on its success. The income to the bank through the sale of its share in units too would depend on the successful performance of the business and enhancement of its net worth, as the price of the units are to be decided based on valuation. Viewed in this light, decreasing partnership in ventures appears to reflect the characteristics of equity relationship more than such partnership in asset financing based on many formats adopted currently, where the bank could usually secure a fixed return on its capital outlay through rentals and unit sales at pre-agreed prices.

Conclusion

Equity based structures could be adopted with advantage for financing projects in a variety of situations. Being expressly designed for financing, these could replace in many instances debt based modes that have been tailored to fit in artificially.

Decreasing partnership, when used in asset financing, merely facilitates common ownership of the asset while allowing one partner to gain from the other, in the form of lease rentals and sale of the share. Therefore, although resulting in some advantages to the client partner as well as the bank, it may not be regarded as a method that is fully reflective of the equity relationship. The possibility of it being construed or abused as an interest-bearing mode should not be underestimated. Its justification essentially depends on the proper and independent functioning of the component contracts. Therefore, measures should be taken for manifesting the different capacities of the parties in a robust manner, especially through fulfilling the duties pertaining to ownership and lease, and accepting the liabilities involved. The pricing of units and lease rentals should be made independent and more realistic.

Ensuring the bank’s title to the asset should not be through the sole means of a legal mortgage. Gaining legal recognition, where possible, could be ideal. Amendments proposed in order to emphasise the sale and lease transactions could be considered. Granting the client an option to purchase the units may greatly enhance the reality of the contracts, in addition to signifying a breakaway from conventional banking practices.

Decreasing partnership in ventures could be an important means for financing projects. The equity structure should not be based on terms favourable to one party, in a manner complementing the existing conventional modes. Replacing the legally binding promise to purchase with an understanding to that effect, giving the partners a choice in the matter, could be more conducive towards the equity relationship. In this regard, the steps proposed in the paper could be taken into consideration.