Running Musharakah Product of Islamic Banks: An Alternative of Running Finance

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Abstract:
Islamic banking system is growing day by day. The new era of Islamic banking is very successful as new products are being introduced by Islamic banks to cater the demands of customer under Shariah guidelines, there was demand of a product for working capital as an alternative to the conventional product of running finance. Running Musharakah Product has been introduced as substitute to Running Finance Product. In this paper the concept of Running Finance as well as Running Musharakah is described, the practical steps of running Musharakah are also illustrated to examine the viability of the product.

Key words: *Islamic Banking, Running Musharakah, Running Finance, Working Capital*

Islamic Banking Industry Worldwide:

From a situation nearly 40 years ago when it was virtually unknown, Islamic banking has expanded to become a distinctive and fast growing segment of the international banking and capital markets. An Islamic banking and financial system exists to provide a variety of religiously acceptable financial services to the Muslim communities. In addition to this special function, the banking and financial institutions, like all other aspects of Islamic society, are expected to 'contribute richly to the achievement of the major socio-economic goals of Islam'.[1] The most important of these are economic well-being with full employment and a high rate of economic growth, socioeconomic justice and an equitable distribution of income and wealth, stability in the value of money, and the mobilization and investment of savings for economic development in such a way that a just (profit sharing) return is ensured to all parties involved. Perhaps

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the religious dimension should be presented as a further explicit goal, in the sense that the opportunity to conduct religiously legitimate financial operations has a value far beyond that of the mode of the financial operation itself.

The encouraging response received from different corners of the Globe resulted in tremendous growth of Islamic Banking in financial world during the recent years while offering innovative financial solutions for basic financial needs in under-served markets especially in the Muslim worlds to complex financial requirement of the modern times, it is seen as a socially responsible and ethical banking model with considerable growth potential.

History of Islamic Banking in Pakistan:

Pakistan has made a bold attempt in 1980's to start Islamic banking by converting the whole banking and financial system into Islamic system. However in the first phase, Pakistan's efforts had to face difficulties due to some reasons such as lack of Shariah complaint mechanism in financial institutions, , lack of public awareness about Islamic economic system, weak political spirit of successive governments for Islamization of economy, lack of socio-economic will etc.

After the historical Supreme Court judgment on 19th December, 1999, Commission for transformation of financial system was formed and the said commission evolved and formed a new approach towards financial sector of Pakistan. This approach includes establishment of full-fledge Islamic Banks, Islamic Banking subsidiaries of existing banks and stand alone branches for Islamic Banking in order to promote Islamic Banking in Pakistan as a parallel banking system which is compatible to conventional banking system and the same is Shariah Compliant.[2]

The new strategy worked very well for Islamic Financial industry in the country as total assets under the management of Islamic Banks in Pakistan reached Rs. 1.745 trillion by the end of June 2016 from Rs. 6.97 billion in December 2002. Total Islamic Banking deposits reached to Rs. 1.461 trillion in June 2016 from Rs. 5 billion in 2002.[3] During this period the share of Islamic Banking assets and deposit in overall banking sector has reached to 13.2 percent. Branch network of Islamic Banking Industry is continued to expand and reached up to a total number of 2146 of Islamic Banking branches in all over the country.[4]

Structure of Islamic Banking:

The role of Islamic banks is defined by M. Ayub as under:[5]

Islamic financial institutions (IFIs) also serve as intermediaries between the saving surplus and the deficit units/households. However, the instrument of 'interest' is replaced with a number of instruments. While conventional banks mainly pay and charge interest in their operations, Islamic financial institutions have to avoid interest and use more than one key instrument as a basis of their intermediary activities. The striking difference is that risks in Islamic banking remain with the ownership as a result of which IFI's share of profit or loss arising on investments and earn return on their trading and leasing activities by dint of the risk and liability taken and adding value in real business activities. They mobilize deposits on the basis of profit/loss sharing and to some extent on the basis of Wakalah against pre-agreed service charge or agency fee.

On the assets side, they take the liability of loss, if any, in case of Musharakah/Mudarabah based financing and bear risk in trading activities so long as the assets remain in their ownership. In leasing activities they purchase the assets, give them on rental and bear ownership related risks as also expenses. It implies that IFIs will remain as intermediary as they would collect savings from a large number of savers/investors for financing the needs of business, agriculture and industry, but their *modus operandi* will change. Their subject matter will be the goods and real business activities.

Islamic banking Products and Services:

The following table 1 presents product wise Islamic advances breakup.[6]

Table 1 Product-wise Islamic advances break-up

Nature of Product / Service	**Modes and Basis**
I. Deposits – Fund Mobilization	
Current Deposits	Amanah – Qard to bank; no return payable
Savings deposits	Mudarabah
General Investment Term Deposits	Mudarabah
Special Investment Deposits	Mudarabah, Close and open ended Mutual Funds, Wakalatul Istismār
Individual portfolios	Mudarabah, Wakalatul Istismār
Liquidity generation	Tawarruq – Reverse Murabaha, sale to any 3rd Party
II. Trade Finance, Corporate Finance:	
Project Finance	Musharakah, Mudarabah based TFCS, Syndication through Mudarabah, Murabaha, Istisna´a, Ijarah / Ujrah
Working capital finance	Murabaha, Salam, Musharakah in single transactions
Export finance – pre-shipment	Salam / Istisna´a plus Murabaha and Wakalah, Murabaha, Musharakah
Import finance	Murabaha, Musharakah
Cash finance	Salam, Istisna´a, Tawarruq (sale to 3rd party)
Export finance - post shipment (Bill discounting)	Qard Hasan in local currency (spot rate) and promise to sell Foreign exchange in future market – exchange rate differential bank’s income; Murabaha if funds needed for next consignment.

Letter of credit	Commission, Ujrah alongwith Murabaha, etc
Letter of Gurantee	Kafalah, service charge
III. Agriculture, Forestry and Fisheries	
Production finance for inputs & pesticides	Murabaha, Salam
Tube-wells, Tractors, trailers, farm machinery & transport (including fishing boats).	Ijarah Munthiah bittamlik, Salam, Murabaha
Plough cattle Milch Cattle & other live stock; Dairy & Poultry	Murabaha, Salam
Storage and other farm construction (viz. sheds for animals fencing etc.)	Diminishing Musharakah or rent sharing
Land Development	Operating Ijarah, Salam
Orchards, nurseries, Forestry.	Salam, Musaqat
IV. Treasury	
Money market – Inter-bank	Mudarabah
Liquidity management	Sale / purchase of permissible securities, Parallel Salam, Tawarruq.
Fund management	Mudarabah, Wakalatul Istismār, trading in permissible stocks & Sukuk.
Trading in Sukuk, stocks	Depending upon the nature of instruments
Forex operations	Unilateral promise to buy/sell foreign exchange simultaneously at pre-agreed rate
V. Personal Advances (including consumer durables & housing)	
Consumer durables	Murabaha / Installments sale
Auto mobiles	Ijarah Munthiah bittamlik, Murabaha
Housing Finance	Diminishing Musharakah, Murabaha
Providing cash for personal needs	Salam if Possible, Tawarruq

Source: Ayub, M (2007, pp. 194-195)

Working Capital Requirement:

There is a need for the product in Islamic banking which cater to the demand of customers regarding working capital finance. In conventional banking, this requirement is fulfilled through Running Finance products. Industry experts in coordination with product developments department have introduced the Running Musharakah product for this purpose.

Running Finance: a Product of Conventional Banking:

Running Finance (RF) is a very common form of borrowing by commercial and industrial concerns, and it is made available either against pledge or hypothecation of goods, produce or merchandise. In RF, a borrower is allowed to borrow money from the banker up to certain limit, either at once or as and when required. The borrower prefers this form of lending due to the facility of paying markup or service charges only on the amount he actually utilizes.

If the borrower does not utilize the full limit, the banker has to lose the return on the un-utilized amount. In order to offset this loss the banker may provide for a suitable clause in the cash finance agreement, according to which the borrower has to pay markup or service charges on at least on one-half or one quarter of the amount of cash finance limit allowed to him, even when he does not utilize the amount.[7]

Musharakah:

'Musharakah' is a word of Arabic origin which literally means sharing. In the context of business and trade it means a joint enterprise in which all the partners share the profit or loss of the joint venture. It is an ideal alternative for the interest-based financing with far reaching effects on both production and distribution. In the modern capitalist economy, interest is the sole instrument indiscriminately used in financing of every type. Since Islam has prohibited interest, this instrument cannot be used for providing funds of any kind. Therefore, Musharakah can play a vital role in an economy based on Islamic principles.[8]

Types of Musharakah:

There are two broad categories of Shirkah or partnership in Islamic jurisprudence. They are Shirkat-al-Milk and Shirkat-al-Aqd. Let us have a look at them.[9]

1. **Shirkat-al-Milk:** Shirkat-al-Milk is also known as proprietary partnership or partnership by ownership. It is further divided into two kinds:
   a. **Optional Partnership (Ikhtiary):** It is obvious from the very name of this kind of partnership. The relationship among the partners or parties comes into existence at their own will and consent.
   b. **Compulsory Partnership: (Ghair Ikhtiary):** It is also known as non-optional partnership. Under this kind of partnership two or more than two persons become partners with out their own effort or consent. The simplest example is the property of the deceased becomes a joint ownership of his/her heirs.

Shirkat-al-Aqd:

Shirkat-al-Aqd is also known as contractual partnership or partnership by contract or joint commercial enterprise. It is an agreement between two or more individuals to share their assets, labor or liabilities for the purpose of earning profit. This type of partnership is affected by the mutual contract among the partners. It is further divided into three major types.[10]

a. **Shirkat-al-Amwal:** The Arabic word Amwal means money or capital. This is a partnership in capital or investment when all members of the contract invest some capital into a business or commercial enterprise.
b. **Shirkat-al-Aamaal:** The Arabic word Aamaal is the plural of Amal which means action, deed, labor or service. Shirkat-al-Aamaal is also referred to as Shirkat-al-Sanai (because the capital of the partners is their skill) or Shirkat-al-Abdan (because the partners perform certain manual labor like tailors, electricians, butchers etc). This is a partnership in services where all members or partners jointly undertake to render some services for their customers and the income earned is distributed among them according to an agreed ratio.
c. **Shirkat-al-Wujuh:** It is known as credit partnership. The word 'Wujuh' is Arabic word which means face, which can be further used for reputation and goodwill. So, the partners in this type of partnership do business using their reputation and goodwill in the market instead of their skill and capital. The people trust in them due to their sense of responsibility and trustworthiness and their entrepreneurship qualities. They buy goods and commodities on credit at deferred price and sell them on the spot for cash. The profit so earned is then distributed at an agreed ratio among them.

Running Musharakah Product as an alternative to Running Finance:

Running Musharakah is Shariah compliant alternative of Running Finance Facility available in conventional banking system. RM is based on the concept of contract of Musharakah (Shirkat-al-Aqd). Basic features of running Musharakah product are as under:[11]

1. RM is a Shariah compliant alternate for conventional running finance facility which is the most popular product amongst the customers.
2. Running Musharakah will allow customer to draw down funds and to adjust the same as and when required without submitting any additional document to the bank (as required in other modes of Islamic financing).
3. The facility shall be offered to the customer who conducts a business declared as Halal and endorsed by Shariah.
4. The profit sharing will be based on Gross Profit of customer business or any profit sharing ratio which shall be mutually agreed upon, in the Musharakah agreement/ contract and subject to revision quarter to quarter/ defined period to period.
5. RM cannot be used for financing/ purchase of fixed assets.
6. The Bank and the Customer will enter into Musharakah, based on Shirkat-ul-Aqd
7. The Bank and the Customer will invest in the identified primary Operating Activities (or any identifiable segment thereof) of the Customer's business
8. Running Musharakah will be used to finance Customer's Operating Activities only.
9. Bank and customer will participate in the profits/(loss) generated by the Musharakah in proportion to their respective Profit sharing Ratios.

10. Payment by the client is done provisionally and temporarily at the end of each Musharakah (Monthly/quarterly/biannual/annual as mutually agreed) period which is subject to final settlement.

Understanding the concept:

In order to calculate total investment a simple working example of Running Musharakah with a retailer who purchases and sells the goods on the same day on cash is taken, thus having nil inventory turnover and average collection periods.[12]

Table 2 A Simple Working Example of Running Musharakah

Days	Total Daily Purchases	Bank Investment Balance	Customer Investment	Total Sales	Profit
	(A)	(B)	(C=A-B)	(D)	(E=D-A)
1	100	50	50	115	15
2	100	70	30	115	15
3	200	40	160	230	30
4	200	60	140	230	30
5	150	30	120	173	23
6	200	60	140	230	30
Total	**950**			**1,093**	**143**
Average	**158**	**52**	**107**		

Source: Authors' own calculations

Total Investment:

Since investment period in Musharakah would not be limited to the purchase/production and sale of goods on cash the same day, therefore the results of the following formula will be used to arrive at Musharakah Total Average Investment:

Adjusted cost of goods sold multiplied by Inventory Turnover in Days and divided by Musharakah tenor + Adjusted COGS multiplied by Average Collection Period in Days and divided by Musharakah tenor.

The Inventory & Accounts Receivable will be based on average of the preceding three quarterly financial statement immediately preceding Musharakah Tenor, normalized for extraordinary changes (if any) in customer business model.

Table 3 Running Musharakah Total Average Investment

Days	COGS	FG*	Acc Rec	Customer	Bank
1	3,000	3,000		2,000	1,000
2		3,000		2,000	1,000
3		3,000		2,000	1,000
4		3,000		2,000	1,000
5		3,000		2,000	1,000
6		3,000		2,000	1,000
7		3,000		2,000	1,000
8		3,000		2,000	1,000
9		3,000		2,000	1,000
10		3,000		2,000	1,000
11			3,000	2,000	1,000
12			3,000	2,000	1,000
13			3,000	2,500	500
14			3,000	2,500	500
15			3,000	2,500	500
16			3,000	2,500	500
17			3,000	2,500	500
18			3,000	2,500	500
19			3,000	2,500	500
20			3,000	2,500	500
21			3,000	2,500	500
Total	**3,000**			**46,500**	**16,500**
Average	**100**			**1,550**	**550**

Source: Authors' own calculations.

* Finished Goods

1. Cost of Goods Sold (COGS) is an income statement item, it relates to the whole period of the business and gives a more accurate picture compared to the Current Asset figures, which are a balance sheet items and portray only the end of period information.[13]
2. Normally COGS is calculated as follows:
   Opening Stock + (Direct Labor + Direct Raw Material + Direct Overheads) – Closing Stock
3. For the purpose of Musharakah the COGS will have to be adjusted to exclude expenses such as repair & maintenance, stores & spares, plant depreciation, plant insurance, etc from direct overheads which are not related to the activities of the Musharakah.
4. The Facility Limit can be calculated as percentage of the average value of Stock-in-Trade and Trade Receivables appearing in the preceding four

financial year statements of the company. For example the following table shows the calculation of Facility Limit for ABC Cement for the year 2016.

Table 4 Facility Limit Calculation for ABC Cement

				Amount in "000"
	2013	2014	2015	TOTAL
Avg of Stock in Trade	144,026	273,594.5	553,837	323,819
Avg of Trade Recievables	19,582	60,598.5	287,528	107,940
BANK'S MAXIMUM LIMIT (at 70%)				431,759
				302,231

Source: Authors' own calculations

Profit and Loss Sharing:

1. The Profit Sharing Ratio between the bank and the customer will be in proportion to their respective investment ratios in the running musharakah up to an agreed profit ceiling
2. The running musharakah loss will be shared between the bank and the customer in proportion to their respective investment ratio

Conclusion:

Keeping in view the demand of the customers as well as the structure of the product it is expected that the product will grab huge share of finance portion in the industry in near future which will be a very good sign for overall growth of the industry because demand of the customer who need running finance will be catered by the product. However some issues of the products are needed to be addressed especially some shariah issues which are related to the distribution of profit and realization of the contribution of partners.

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