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Partnership (Musharaka) In Islamic Economics

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musharaka, diminishing musharaka, shirkat al-milk, shirkat al-aqd, shirkat al-inan, shirkat al-mufawada.

Abstract

The term musharaka is derived from the Arabic word *shaaraka*, which means "to share" or "to enter into partnership." In practice, musharaka (*shirkat al-inan*) refers to an arrangement between two or more parties based on the sharing of profit and loss. Under this contract, each participating party contributes a certain amount of capital, and this contribution gives that participant the right to dispose of or manage the partnership capital. The profit earned from the partnership's activities is distributed among the partners according to a ratio agreed in advance in the contract, while any loss incurred is distributed in proportion to each partner's share in the musharaka capital. The ratio for profit distribution may differ from the ratio for loss distribution.

Keywords: musharaka, diminishing musharaka, shirkat al-milk, shirkat al-aqd, shirkat al-inan, shirkat al-mufawada.

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The main characteristics of musharaka are as follows:

1. Parties to the musharaka contract: A musharaka partnership may be established between two or more parties.
2. Musharaka capital: All participants must contribute their shares to the musharaka capital. The capital may be in the form of cash or tangible assets. The contribution may be made as a one-time payment or in installments over time, and it may even be paid in different currencies. Borrowed funds are not permitted to be contributed as partnership capital.
3. Management of musharaka activities: In musharaka, all participants have equal rights in managing the business. However, in practice, management may be assigned to one or several participants. A separate contract is concluded with the partner or partners who undertake managerial duties. Management may also be entrusted to an external person who has the relevant expertise and experience, in which case the relationship is arranged under an *ijarah* employment contract.
4. Guarantees in musharaka activities: All partners must conduct the partnership on the basis of mutual trust. Therefore, ordinarily no partner is held liable for circumstances beyond his control. However, if any partner fails to fulfill his obligations properly during the course of the musharaka, acts negligently, or breaches the terms of the contract, that partner will be liable for losses resulting from such conduct. In addition, third parties may be engaged as guarantors for the safekeeping of the partners' capital.
5. Profit distribution: The distribution of profit generated by musharaka must be agreed upon by the partners at the time the contract is concluded. A partner's share of profit may differ from that partner's share in the total capital. The profit share cannot be fixed as an absolute amount of money or as a percentage of the capital itself. In calculating profit, the partners may apply either a fixed or variable method. For example, after the first accounting period, profit may be distributed

according to one ratio, and after the second accounting period according to another. It may also be agreed that if profit exceeds a certain level, the excess belongs to one of the partners.

6. Loss distribution: Any loss incurred in the course of musharaka must be distributed among the participants strictly in proportion to their contributions to the capital.

7. Termination of musharaka: Each participant has the right to terminate the musharaka, provided prior notice is given. Conversely, the partners may also undertake a binding promise to continue the musharaka for a certain period. When the term of the musharaka expires, the existing assets are distributed among the partners according to a predetermined ratio. If this is not possible, one of the partners may purchase all the assets at market value. By mutual agreement, the musharaka may also be terminated voluntarily before the end of its term. In addition, if one of the partners dies or becomes legally incapable of participating in the musharaka, that partner's participation comes to an end.

8. Diminishing musharaka: All general rules applicable to musharaka also apply to diminishing musharaka. In this arrangement, one partner periodically purchases the other partner's share through regular payments.

Types of Musharaka

In the literature on Islamic economics and finance, various approaches are used to classify musharaka. However, in terms of origin, there are two main types of partnership, and the other forms are derived from these two.

1. Shirkat al-Milk

Shirkat al-milk refers to joint ownership of a specific property. It has two subcategories:

- Shirkat al-ikhtiyar: voluntary joint ownership, in which two or more persons voluntarily purchase and own a certain asset together. For example, they may purchase real estate or equipment and lease it out. Joint ownership may also arise where property is gifted or bequeathed to two or more persons.
- Shirkat al-jabr: compulsory joint ownership, which arises through inheritance.

A distinctive feature of shirkat al-milk is that the partners are treated as strangers to one another in relation to their shares, meaning that one partner may not dispose of the other's share without permission.

2. Shirkat al-Aqd

Shirkat al-aqd refers to partnership established by contract. This type of partnership is further divided into three major categories:

- Shirkat al-amwal: partnership through the contribution of wealth, property, or investment capital. The main features of the musharaka contract discussed here belong to this type of partnership. Shirkat al-amwal is itself divided into two subcategories:
    - Shirkat al-mufawada: a form of partnership in which all partners contribute equal shares of capital. For example, if there are two partners, each owns 50% of the capital; if there are four partners, each owns 25%, and so on.
    - Shirkat al-inan: the general form of partnership. In this type, there is no restriction or set standard regarding each partner's share in the total capital. Most musharaka contracts are conducted on the basis of shirkat al-inan.
- Shirkat al-a'mal: a form of partnership based on labor or the provision of services. In this arrangement, two or more parties enter into partnership to perform a particular task or provide services.
- Shirkat al-wujuh: a form of partnership in which persons use their good reputation or creditworthiness to purchase goods on deferred payment and then sell them for cash. This is more commonly undertaken by persons who enjoy a good reputation among the public and have earned people's trust. From the perspective of legal entities, this type of partnership may also be undertaken by companies with a strong credit history based on their previous transactions. A company's reputation and brand recognition are also important in choosing partners and obtaining assets on credit.

Some literature also identifies mudaraba as a type of partnership. However, most sources treat mudaraba as an independent subject because of its broader scope and distinct characteristics. In addition, muzara'ah - where one party contributes land and the other contributes seeds or seedlings in agricultural activity - and musaqat - where one party contributes fruit trees or plants and the other contributes by irrigating and maintaining them - are also mentioned as forms of partnership.

Mechanism for Implementing Musharaka

In the economy, musharaka is most commonly implemented among legal entities in forms such as joint ventures, shareholding companies, and joint-stock companies. Because of their broader financial capacity, Islamic banks also participate in this process. Below is a mechanism illustrating how musharaka operates between an Islamic bank and its partner, whether an individual or a legal entity:

- An agreement is concluded between the Islamic bank and the prospective partner to carry out a specific business project under a musharaka arrangement.
- Both parties contribute their shares to the musharaka capital. For example, the bank may contribute 80% of the capital and the entrepreneur 20%.
- The parties agree on a profit-sharing ratio, for example 60:40, under which 60% of the profit generated by the musharaka activity goes to the bank and 40% to the entrepreneur.
- If the activity results in a loss, 80% of the loss is borne by the bank and 20% by the entrepreneur.
- In a diminishing musharaka, one of the partners, usually the customer working with the bank, begins to purchase the bank's share in the jointly owned asset through periodic payments. Once all payments are completed, the customer becomes the sole owner of the asset.

Many productive and financial activities may be conducted using the musharaka contract. The areas most commonly used by banks include:

- financing the purchase of housing;
- project financing;
- trade financing through issuing a Letter of Credit on a musharaka basis;
- financial operations involving shares and stocks;
- the activities of Islamic investment funds;
- issuing sukuk on the basis of musharaka.

The discussion above has already described the use of musharaka in home financing and participation in specific projects. Below is an explanation of how musharaka is used in trade financing through the issuance of a letter of credit and in the implementation of musharaka sukuk.

Trade Financing Through a Musharaka-Based Letter of Credit

A letter of credit is mainly used in international trade as an additional guarantee instrument for financing imports. In Islamic economics, the concept of a musharaka-based letter of credit is also applied. In this case, the musharaka capital under the letter of credit refers to the investment contributed under the musharaka arrangement between the Islamic bank and the customer.

The process works as follows:

The importer approaches the Islamic bank to enter into a musharaka agreement and informs the bank of the requirements relating to the letter of credit. The importer deposits a certain percentage or portion of the cost of the goods to be purchased as part of the musharaka capital. The Islamic bank opens the letter of credit and pays the cost of the imported goods to the bank acting on behalf of the exporter, using its own funds together with the customer's deposit. The exporter sends the shipping documents to its bank, which in turn forwards them to the importer's bank. The Islamic bank presents the shipping documents received from the exporter's bank to the importer. On the basis of these documents, the importer takes possession of the imported goods and sells them or otherwise disposes of them in accordance with the terms set out in the musharaka agreement. The importer and the Islamic bank distribute the profit from the sale of the imported goods according to the ratio agreed in advance. If the transaction results in a loss, that loss is covered by the partners in proportion to their respective shares in the total capital.

In a musharaka letter of credit, the Islamic bank opens the letter of credit in its own name and acts as a passive partner in the musharaka. The customer, by contrast, acts as the active managing partner, and for this reason may be allocated a greater share of the profit than the bank. In addition, the Islamic bank is not permitted to demand any guarantee from the customer for earning a return on the capital it contributes.

Musharaka Sukuk

At present, there are several types of sukuk, one of which is musharaka sukuk. This type belongs to the category of asset-based sukuk. According to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), musharaka sukuk certificates are intended to raise financial resources under partnership contracts for the establishment of new projects, the development of existing ones, or the financing of business activities. Holders of such sukuk certificates become owners, in proportion to their shares, of the projects mentioned above and of the operational assets involved. The issuers of the certificates are those

inviting participation in the partnership, while the purchasers of the certificates become the contractual partners. In such a case, the funds raised constitute the participants' contributions to the musharaka capital. Certificate holders own shares in the partnership capital and share in both profit and loss.
The entity that issues the sukuk is a Special Purpose Vehicle (SPV). In sukuk issuance, two forms of musharaka are mainly used: shirkat al-aqd and shirkat al-milk. Below is the operating mechanism of sukuk based on shirkat al-aqd:

1. The SPV presents the project, and investors contribute their financial resources to participate in it.
2. After the funds have been collected, the company issues sukuk certificates to the investors. These certificates indicate that their holders have undivided ownership in the partnership asset. They also entitle the sukuk holders to receive their share of periodically distributed profits and to obtain the amount due upon exit from the partnership or upon its liquidation.
3. The SPV acts as a trustee for all processes related to the sukuk and operates on behalf of the investors.
4. The SPV enters into a musharaka agreement with the originator partner, and the two agree on the contributions each will make under the contract.
5. The SPV provides the funds raised from the investors to the originator partner as its share in the musharaka capital.
6. The originator partner, in turn, transfers certain units of its assets to the SPV as its contribution to the capital. As a result of steps 5 and 6, all the capital required for the musharaka activity is assembled.
7. In addition to its capital contribution, the originator partner manages the business or assets established under the musharaka.
8. In each distribution period, the originator partner pays to the SPV the profit derived from the musharaka enterprise or musharaka assets in accordance with its capital share or the ratio agreed in advance.
9. If the SPV's actual share, meaning the absolute amount received, exceeds what had been expected, the excess may be granted to the originator partner as an incentive for good performance.

10. The SPV distributes the profit for each distribution period to the investors.
11. If a loss occurs, the SPV and the originator partner bear it in proportion to their respective shares in the capital.
12. At the end of the contract term, the investors return the sukuk certificates to the SPV in order to receive the final distribution.
13. At the end of the contract term, the originator partner pays the final distribution to the SPV.
14. The SPV then pays the investors the final profit distributed upon exit from the partnership.
15. At the final stage, the originator partner is obligated to purchase the musharaka assets.
16. Likewise, at the final stage, the SPV is obligated to sell the musharaka assets to the originator partner.

All of the above processes relating to musharaka sukuk are fully subject to the rules governing musharaka. In addition, at least 33% of the musharaka assets, or according to some scholars up to 50%, must consist of tangible assets. This requirement is intended to ensure the tradability of the assets. The originator partner and the SPV may terminate the musharaka agreement at any time, provided they give prior notice to one another.

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