

OBJECTIONS ON MUSHARAKAH FINANCING

1. Risk of Loss
2. Dishonesty
3. Secrecy of the Business
4. Clients' Unwillingness to Share Profits

Risk of Loss

It is argued that the arrangement of musharakah is more likely to pass on losses of the business to the financier bank or institution. This loss will be passed on to depositors also. The depositors, being constantly exposed to the risk of loss, will not want to deposit their money in the banks and financial institutions and thus their savings will either remain idle or will be used in transactions outside of the banking channels, which will not contribute to the economic development at national level.

This argument is, however, misconceived. Before financing on the basis of musharakah, the banks and financial institution will study the feasibility of the proposed business for which funds are needed. Even in the present system of interest-based loans the banks do not advance loans to each and every applicant. They study the potentials of the business and if they apprehend that the business is not profitable, they refuse to advance a loan. In the case of musharakah, they will have to carry out this study with more depth and precaution.

Moreover, no bank or financial institution can restrict itself to a single musharakah. There will always be a diversified portfolio of musharakah. If a bank has financed 100 of its clients on the basis of musharakah, after studying the feasibility of the proposal of each one of them, it is hardly conceivable that all of these musharakahs or the majority of them will result in a loss. After taking proper measures and due care, what can happen at the most is that some of them make a loss. But on the other hand, the profitable musharakahs are expected to give more return than the interest-based loans, because the actual profit is supposed to be distributed between the client and the bank. Therefore, the musharakah portfolio, as a whole, is not expected to suffer loss, and the possibility of loss to the whole portfolio is merely a theoretical possibility which should not discourage the depositors. This theoretical possibility of loss in a financial institution is much less than the possibility of loss in a

joint stock company whose business is restricted to a limited sector of commercial activities. Still, the people purchase its shares and the possibility of loss does not refrain them from investing in these shares. The case of the bank and financial institutions is much stronger, because their musharakah activities will be so diversified that any possible loss in one musharakah will be more than compensated by the profits earned in other musharakahs.

Apart from this, 'an Islamic economy must create a mentality which believes that any profit earned on money is the reward of bearing risks of the business. This risk may be minimized through expertise and diversifying the portfolio where it becomes a hypothetical or theoretical risk only. But there is no way to eliminate this risk totally. The one who wants to earn profit, must accept this minimal risk. Since this understanding is already there in the case of normal joint stock companies, nobody has ever raised the objection that the money of the shareholders is exposed to loss. The problem is created by the system which separates the banking and financing from the normal trade activities, and which has compelled the people to believe that banks and financial institutions deal in money and papers only, and that they have nothing to do with the actual results emerging in trade and industry. Therefore, it is argued that they deserve a fixed return in any case. This separation of financing sector from the sector of trade and industry has brought great harms to the economy at macro-level. Obviously, when we speak of Islamic banking, we never mean that it will follow this conventional system in each and every respect. Islam has its own values and principles which do not believe in separation of financing from trade and industry. Once this Islamic system is understood, the people will invest in the financing sector, despite the theoretical risk of loss, more readily than they invest in the profitable joint stock companies.

Dishonesty

Another apprehension against musharakah financing is that the dishonest clients may exploit the instrument of musharakah by not paying any return to the financiers. They can always show that the business did not earn any profit. Indeed, they can claim that it has suffered a loss in which case not only the profit, but also the principal amount will be jeopardized.

It is, no doubt, a valid apprehension, especially in societies where corruption is the order of the day. However, solution to this problem is not as difficult as is generally believed or exaggerated.

If all the banks in a country are run on pure Islamic pattern with a careful support from the Central Bank and the government, the problem of dishonesty is not hard to overcome. First of all, a well-designed system of auditing should be implemented whereby the accounts of all the clients are fully maintained and properly controlled. It is already discussed that the profits may be calculated to the basis of gross margins only. It will reduce the possibility of disputes and misappropriation. However, if any misconduct, dishonesty or negligence is established against a client, he will be subjected to punitive steps, and may be deprived of availing any facility from any bank in the country, at least for a specified period.

These steps will serve as strong deterrent against concealing the actual profits or committing any other act of dishonesty. Otherwise also, the clients of the banks cannot afford to show artificial losses constantly, because it will be against their own interest in many respects. It is true that even after taking all such precautions, there will remain a possibility of some cases where dishonest clients may succeed in their evil designs, but the punitive steps and the general atmosphere of the business will gradually reduce the number of such cases (Even in an interest-based economy, the defaulters have always been creating the problem of bad debts) But it should not be taken as a justification, or as an excuse, for rejecting the whole system of musharakah.

Undoubtedly, the apprehension of dishonesty is more severe for the Islamic Banks and Financial institutions working in isolation from the main stream of conventional banks. They have not much support from their respective governments and central Banks. They cannot change the system, nor can they impose their own laws and regulations. However, they should not forget that they are not just commercial institutions. They have been established to introduce a new system of banking which has its own philosophy. They are duty bound to promote this new system, even if they apprehend that it will reduce the size of their profits to some extent. Therefore, they should start using the instrument of musharakah, at least on a selective basis.

Each and every bank has a number of clients whose integrity is beyond all doubts. The Islamic banks should, at least, start financing them on the basis of true musharakah. It will help setting good precedents in the market and induce others to follow suit. Moreover, there are some sectors of financing where musharakah can be used easily. For example, the use of musharakah instrument in financing exports has not much room for dishonesty. The exporter has a specific order from abroad. The prices are agreed. The cost is not difficult to determine. Payments are normally secured by a letter of credit. The payments are made through the bank itself. There is no reason in such cases why the musharakah arrangement should not be adopted. Similarly, financing of imports may also be designed on the basis of musharakah with some precautions, as explained earlier in this chapter.

Secrecy of the Business

Another criticism against musharakah is that, by making the financier a partner in the business of the client, it may disclose the secrets of the business to the financier, and through him to other traders.

However, the solution to this problem is very easy. The client, while entering into the musharakah, may put a condition that the financier will not interfere with the management affairs, and he will not disclose any information about the business to any person without prior permission of the client. Such agreements of maintaining secrecy are always honored by the prestigious institutions, especially by the banks and financial institutions whose entire business is based on confidentiality.

Clients' Unwillingness to Share Profits

Many a time, it is mentioned that the clients are not willing to share with the Banks the actual profits of their business. The reluctance is based on two reasons:

1. They think that the bank has no right to share in the actual profit, which may be substantial, because the bank has nothing to do with the management or running of the business and why should they (the clients) share the fruit of their labour with the Bank who merely provides funds. The Clients also argue that conventional banks are content with a meagre rate of interest and so should be the Islamic Banks.
2. Even if the above was not a factor, the Clients are afraid to reveal their true profits to the Banks, lest the information is also passed on to the tax authorities and Clients' tax liability increases.

The solution to the first part, though not easy, is not difficult or impossible either. Such Clients need to be convinced and persuaded that borrowing on interest is a cardinal sin, unless there is a dire necessity for such borrowing. Mere expansion of business is not a dire need, by any stretch of imagination. By making a legitimate arrangement for obtaining funds for their business, by way of Musharakah, not only do they earn Allah's pleasure but also a legitimate return for themselves, as well as for the Islamic Banks.

In respect of the second factor, all that can be said is that in some muslim countries, rate of taxation are indeed prohibitive and unjust. Islamic Banks as well as their Clients must lobby with the governments and struggle to change the laws which hamper the progress towards Islamic banking. The governments should also try to appreciate the fact that if rates of taxation are reasonable and if the tax-payers are convinced that they will benefit by honestly paying their taxes, this would increase, and not decrease, government revenues.