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Mushārakah in Constructing Housing Flats

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Abstract. *Mushārakah* financing is Sharī'ah based equity financing, which is rarely utilised in the banking practices due to multiple risk exposures in partnership based ventures. This case article pertains to *mushārakah* project financing by a bank in Pakistan to highlight different types of risks associated with implementation of *mushārakah* based financing in the industry. The approach adopted in this research study is narrative based where different steps for the implementation of *mushārakah* financing including associated risks and issues are highlighted in terms of compliance with Sharī'ah, particularly in the context of using *mushārakah* in the construction of residential flats.

KAUJIE Classification: J3, K3
JEL Classification: R3, G2

INTRODUCTION

Ideally, equity based financing based on commercial partnership (*Shirkah al-'aqd*), pre-Islamic in nature (Choudhury, 2004), is one of the core pillars of Islamic banking system. However, data about financing by Islamic banks show that such modes of financing have limited role in the financial compositions of Islamic banks compared to the other modes of financing (Jan & Asutay 2018; Nouman & Ullah, 2014). According to Jan and Asutay (2018), *mushārakah* and *muḍārabah*, together contributed just over 6 percent of total financing by Islamic banks globally compare to 71 percent by *murābaḥah* and deferred sale. [1]

It is argued that in practice, *mushārakah* and *muḍārabah* based financing are inherently vulnerable to agency problem as entrepreneurs have less incentives to put in required effort

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[1] Even this 6 per cent might be having some problems making such financing doubtful if the basic *muḍārabah* principles are kept in view as the case of running *muḍārabah* in Pakistan, as we will discuss in following paras.

and may be inclined to report less profit as compared to the self-financing owner-manager (Dar & Presley, 2000). Furthermore, due to moral hazards, entrepreneurs can divert cash flows from the project either through the consumption of perquisites or through wasteful spending (Jan, 2013).

What is *Mushārakah* Financing?

Mushārakah financing is a Sharī'ah based financing where bank and entrepreneur both supply the capital and share management and profit of the entity or project. In case there is a loss in the project, both parties share the losses in proportion to the contribution of the capital, which could exceed the initial investments, as it is an unlimited liability, whereas, profits proportions are negotiated freely between the bank and entrepreneur (Jan & Asutay, 2018; Ullah & Al-Karaghouli, 2017).

Mushārakah Based Project Financing: A Case Study of Islamic Bank

Although *mushārakah* financing is a preferable mode of financing for Islamic Banking Institutions (IBIs), very limited instances have been seen where IBIs have engaged in real partnership based financing in real sense [2]. This case study documents first ever *mushārakah* contract initiated by the bank in Pakistan. The narrative highlights many issues and risks faced by the bank during the course of implementation of the *mushārakah* financing.

The Start of *Mushārakah* Based Venture

The customer, who was a well-reputed local entrepreneur, approached the management with a business proposal utilising *mushārakah* contract where the bank will be another partner. However, even though, the bank was interested in the proposal, there was no formal documentation with the bank to initiate *mushārakah* contract. Initially, the bank and entrepreneur signed an Memorandum of Understanding (MOU) to explore investment opportunities. After the MOU, the bank immediately initiated the processes by requesting the Sharī'ah Board secretariat of the Bank to prepare complete policy document for the *mushārakah* contract. After the initial draft and approval from the Sharī'ah board, the document was submitted to the Board of Directors (BOD) of the bank for approval. Once it was approved from the BOD, the document was forwarded to the State Bank of Pakistan for their input.

The Objective of *Mushārakah* Financing

In Islam, it is unlawful to indulge in business activities, which derive their profits from interest (*ribā*), gambling, and other harmful activities. In this situation, the proposal given by a private sector entrepreneur was about construction of apartment buildings, which falls in *ḥalāl* activities. After policy formation and approval of the *mushārakah* product and the

[2] There has been some investments in stocks, Islamic funds or such instruments, but the *mushārakah* based financing has been near to zero in Pakistan. Since last some years, however, IBIs in Pakistan are reporting increasing share of *mushārakah*, but that is 'Running *mushārakah*' which is claimed to be an exact alternative to the conventional Overdraft (OD), and hence, a fixed return is charged invariably as per banks's target rate in the agreement entered to in the begining. This fixed rate financing cannot be termed as *mushārakah* in real sense (Khaleequzzaman, Mansoori, & Rashid, 2016; Tahir & Khan, 2016; Ayub, 2016).

process from SBP, the manager of local branch of the bank approached the entrepreneur to initiate the application for *mushārakah* financing. Since, this was first of its kind contract, there were no expertise from both parties and extreme care was taken at each step. The entrepreneur was requested to submit documents of previous experience, his business accounts, and provide personal guarantees.

The complete application was forwarded to the Bank's Head Office Credit Committee (HOCC) for approval. Since the bank was operating as conventional bank with Islamic window, therefore, the HOCC was headed by a person with conventional experiences. The objection raised by the HOCC was as to how the return would be guaranteed, and only in that case the project could be approved. In *mushārakah* financing, there could be no fixed return based on the benchmark approved in the begining, whereas in conventional banking, such parameters are defined and agreed upon before the project is initiated. The Sharī'ah Board at the time, had to play an important role to not only educate the members of HOCC about how *mushārakah* financing is executed according to Sharī'ah standard, but also to get the approval from the HOCC. After several meeting with the HOCC, the contract was finally approved.

The Investment and Profit and Loss Distributions

The second requirement from a Sharī'ah compliance perspective was to agree on the proportion of investment by both, the bank and entrepreneur. The bank agreed to 80 to 20 ratios in partnership with the entrepreneur, where bank will contribute 80 percent of total investment and entrepreneur will invest 20 percent for acquisition of land and construction of apartments. Third condition of the contract was the proportion of profit distribution among the parties. Since, the bank was not supposed to play much active role, and all activities of the construction of the apartments had to be managed by the entrepreneur, therefore, both parties agreed to 40 to 60-profit distribution - bank getting 40 percent from the actual profit and the entrepreneur getting 60 percent. Furthermore, according to Sharī'ah, in case of losses, each party would be bearing the losses according to their percentage of initial investments (80:20). The total value of the investment of the project was 43.083 million Pakistani rupees, where the bank agreed to contribute 34.46 million of the total investment. The timeline for the project completion was 2 years from the date of first disbursement. Furthermore, *takāful* policies of the project, construction portion only, covering risk of fire, earthquake, and accident and death and all other natural calamities were obtained from a bank's approved reputable *takāful*/company.

The Banking related Jobs and Processes

In the second step, the bank opened a *mushārakah* investment account, jointly with the entrepreneur. To acquire the land, the bank and entrepreneur deposited the initial equity of Rs. 13.475 million according to their proportion of investments after satisfying all arrangements including but not limited to Satisfactory Valuation of Land by SBP Approved Valuator, Satisfactory Visit Report of BOK's Professional Evaluator, clear & marketable title documents, and transparency of the transaction. The payment to the original owner of the land was made through crossed payment order. It was the responsibility of the entrepreneur to ensure that the payment is made to actual owner(s) or their authorized person, to avoid any dispute later on. Even though the land was jointly purchased, but in order to meet the Security Requirements as per SBP prudential requirements, the land was exclusively transferred in name of the Bank as per the consent of the entrepreneur and consequently the entire project was in name of the Bank. This was subject to clear legal opinion from BOK's approved Legal advisor that prevailing laws / regulations do not prohibit the bank from doing so. The next step was to hire an architect for the designing the building. Neither bank nor the entrepreneur had any experience in the construction of the apartment building, therefore, it was agreed to hire the service of builders to manage the construction on daily basis. The entrepreneur, as an active partner to *mushārakah* contract with the bank, was to monitor the processes to meet the deadline of the project while assuring the quality of the construction as per given specifications. The details of the project are provided in Table 1.

TABLE 1
Project specifications

Land	55 Marlas (1,664 Square yards / 14,974 Sq Feet .)
Covered Area	31,405 Sq.ft [project was multistorey; Ground plus 3 / 4]
Building Plan	02 Blocks
Specification	Each flat consisted of Drawing, Lounge, 03 bedrooms with attached baths, one dressing, Kitchen, Store and Servant room.

Since, this was the first project of its kind by the bank, therefore, the bank had not planned how day-to-day purchases would be managed. Therefore, in the third stage, the bank formed three members committee for the purpose of supervision and day-to–day activities like acquisition of raw material, etc. The committee was authorised to approve any requisition for raw material to make sure the processes was running smoothly. The committee used to inspect the site and estimate the actual cost before giving approval for purchase and payments accordingly. The committee was responsible to monitor the budget of the *mushārakah*-based project.

The Construction and Onward Booking of Aprtments

During the construction, the bank proposed that instead of devoting a huge sum of money for construction of the project by both parties, the project should be advertised for sale in advance and proceeds from the sales should be used for the construction along with the partners one investments. As suggested by the entrepreneur, the apartments project was advertised in a local newspapers. The response from the people who were interested in the acquiring the apartments was overwhelming and all apartments were booked by the ultimate purchasers who paid the booking amounts and undertook to keep on paying the instalments. The bank created another account, *mushārakah* Collection Account, where the proceeds from the sales of apartments on turnkey basis were to be credited. Neither bank, nor the entrepreneur expected such a response from the market.

The Project Revenues and Associated Risks

Due to high demand from the market, the proceeds from advanced sales were Rs. 13.907 million. The bank and entrepreneur were able to sell the entire building for 56.465 million, while the total profit on *mushārakah* was Rs. 13.382 million, which was distributed according to the proportion of investment agreed upon at the beginning of the contract. The actual return on investment for the bank after the completion of the construction and distribution it with the entrepreneur was 23 percent per annum. This return from the project was more than any bank had ever generated from any kind of financing. The bank was able to distribute one of the highest returns to the depositors in the market. It implied that return on equity based / *mushārakah* financing could be higher that the average return of the banks in the market.

However, as there is no guarantee of higher returns in such financing, the exposure to risk for the bank was also high. It is just according to the principle that greater the risk, higher the expected profits, but more the chance of loss. *Mushārakah* based investment involves a unique risk, which conventional financial institutions do not face in general. Furthermore, higher return to depositors can also expose other banks to displaced commercial risk, where for higher returns, deposit holders of other Islamic banks might switch over their account to such banks,which generate higher returns. The process flow of the *mushārakah* project is also shown in Figure 1.

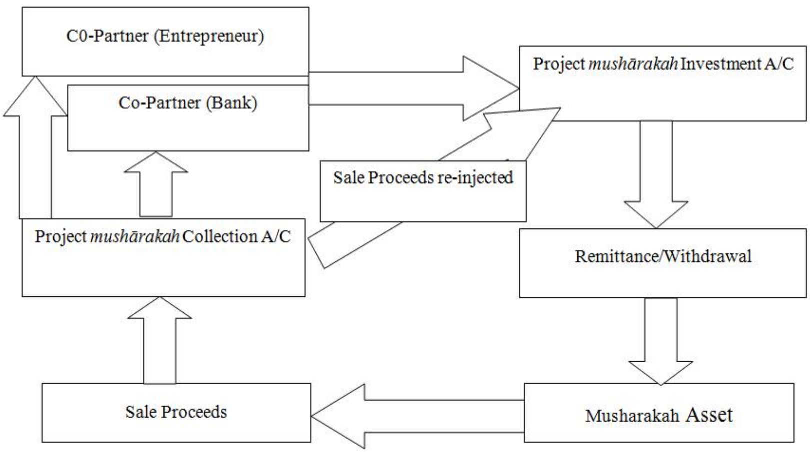

FIGURE 1. Project *mushārakah*

The Second Phase and Realisation of Risks

After successful completion of this project, the bank decided to continue the *mushārakah* financing for another construction project with the same entrepreneur. Accordingly, the land adjacent to the previous project was acquired. The bank expected to build upon their learning from the first project of construction to build luxury apartment for even higher return. The bank decided to be more aggressive with the marketing strategy to reduce the bank's investment in the project by financing the construction from the customers' money that the *mushārakah* project received through advance bookings. However, all of sudden, the city experienced a surge in law and order problem due to terrorist activities and even those who already had investment in real estate business were selling at lower prices to move their investments to other cities. As a result, the bank failed to generate the same level of interest among the people this time as was in case of the first project.

The bank had not counted for the security related risk in the project and suffered a major drawback in meeting its miles stones. The bank, however, continued with the construction, hoping for improvement in the law and order situation. After completing 80 percent construction, the bank and the entrepreneur decided to promote the sale of apartments through media with flexible schemes of payments and allowed payments in installments over the period of time. However, even such strategies failed to generate people's interest.

Another issue emerged that due to change of the government in the province, the newly elected BOD of the bank and the top management was not in favor of taking any bold steps in the emerging situation due to law and order problem. This situation created a problematic situation with regard to the *mushārakah* project. The management were left with two options, either to continue with the construction work to complete the construction, or stop the construction at that stage. The first option had a risk for the bank to commit huge investment with no guaranteed sale in the future, whereas, the second option to stop the construction was also costly as the construction company demanded for full payment as per agreement and it was challenging to sell unfinished apartments in the future.

In the end, the bank's management decided to put the project on hold to avoid further losses. However, the entrepreneur, who was the partner with the bank, wanted to dispose off his 20 percent share in the market to liquidate his investment, in case the bank was not willing to purchase. In *mushārakah* contract, this is not an easy step, as shares of both parties in the construction were undivided and both parties owned the construction as per their investment ratio. It was also impossible to divide the apartments in parts and sell in the market. After evaluating many proposals from the market, the bank's management decided to acquire the entrepreneur's proportion of investment as well, which further increased the amount of investment by the bank, reaching total investment in the project to Rs. 56.008 million.

Bank was offered many proposals from investors over the period of time but those offers did not meet the bank's expectations. In 2015, however, bank auctioned and in nominal terms, the bank earned Rs. 10 million. However, taking into account the time value of investment, the bank reduced the profit in accounting through yearly depreciation of the entire project declaring no return on account for this project. Many of the managers believed that not declaring any profit was more of accounting nature than really a loss. In accounting principles, however, depreciation is an allocation of cost on the assets used in the operations while the building was not used in the operations. As such, Rs. 10 million could perhaps be treated as gain, rather than showing nill profit.

The complete details of *mushārakah* contract execution in the bank is shown Figure 2.

FINDINGS

The narrative of *mushārakah* based financing has many lessons to learn in respect of promoting partnership based financing by Islamic banks that is considered to be the best alternative to interest in Islamic finance for achieving objectives of socio-economic development and alleviating exclusion of the poor in a developing Islamic country like Pakistan. The main finding is that bank's involvement in real business by way of *mushārakah* or *muḍārabah* has huge potential of enhancing bank's returns. However, the financing and investment decisions must be free from political interference and there must be room for change in policy if the market and the business environment changes. It is evident from the narrative that both the bank and the partner earned very good profit on the first project. The problems in the second project should have been resolved through proper change in the investment and marketing strategy. But, the new BOD of the Bank considered it a political issue and did not provide management committee proper flexibility to take firm decisions in line with changing business realities.

Secondly, the bank's risk management policies should also have been more prudent to cover the possible risks in the business environment due to the law and order situation. The Province had been facing the problem for last two decades due to continuing instability in neighbor country Afghanistan and the related situation must have been taken into account while planning such real sector projects.

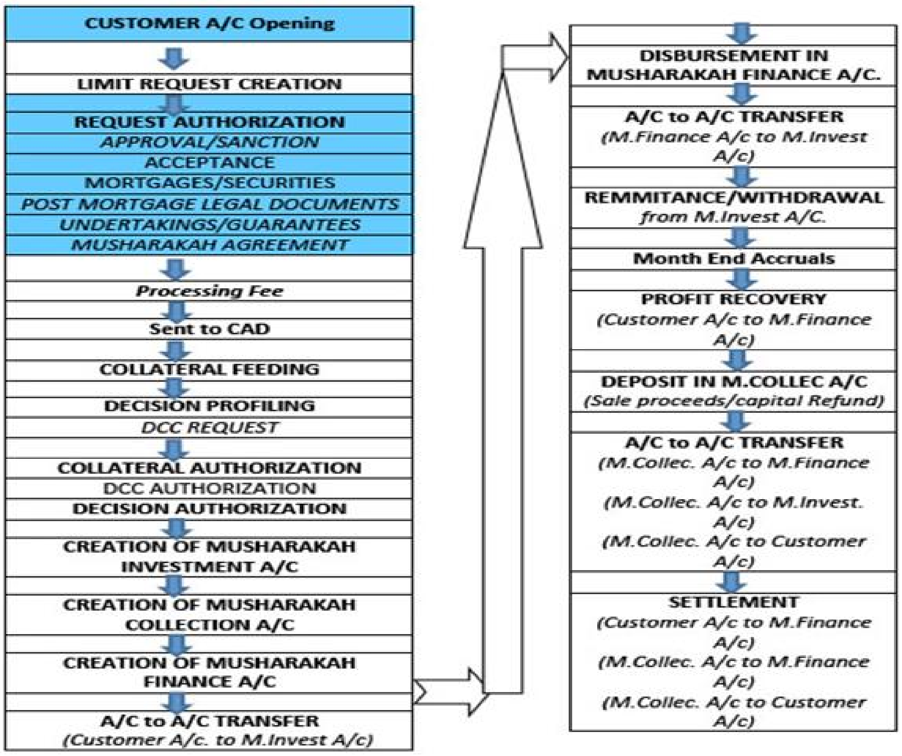

FIGURE 2. *Mushārakah* contract execution process

Thirdly, although the bank earned very good profit on the first project, but the return given to the depositors whose funds were invested for the project were not given communserate return. This is due to the fact that in Pakistan the banking system is working on dual basis, where conventional and Islamic banking system are running side by side. The Islamic banking policies cannot be implemented effectively in this system, particularly to avoid the displaced commercial risk faced by the banks. Hence, it may be suggested to transform the entire banking system to Islamic system wherein the banks would be involved in real business and production activities and their profits could be shared with the depositors.

For the time being, the State Bank of Pakistan may advise the IBIs to change partially their strategy of raising deposits for specific projects. "Fund before lending" is an old policy of getting deposits. Islamic banks should adopt ‘Direct Funding Model’: Islamic banks need to first identify the projects via any Investment Accounts Platforms (IAP). Then they may arrange financiers to associate the depositors with real business and economy on the basis of *muḍārabah* and *mushārakah*, or any other permissible modes. (Ayub, 2017; Islamic Bankers, Nov 2016). This arrangement is nearer to the concept of venture capital, a business area that Islamic finance has not explored so far. This direct funding model may automatically lead to promotion of equity based financing.

TEACHING NOTES

Objectives of the Case:

- The case aims to make the students understand:
- The concept and practice of *mushārakah*?
- The use of *mushārakah* in financing?
- The mechanism of investments and profit distributions in *mushārakah*
- The risks associated with the *mushārakah*

Suitability of the Case Article:

The case is suitable for the undergraduate and post graduate students studying Islamic modes of finance and risk management in Islamic financial institutions.

Analysis Questions:

1. Please develop a complete process flow of *mushārakah* financing for financing housing flats constructs.
2. Please calculate the missing values of the project:

TABLE 2
Break up of project cost

Land Price 55 Marlas @Rs.245,000/- per Marla	Rs.13.475 Million
Covered Area	31,405 Sq.ft
Construction	@ 750/- sq.ft Rs.23.554 M
Other Expenses i.e lifts etc	Rs.06.054 M
Total Cost of the project	

Calculate the Missing values in the following Table:

TABLE 3
***Mushārakah* project for apartments**

Bank: Entrepreneur Investment Ratio	80:20
Profit Sharing Ratio	60: 40
Loss Sharing Ratio	80:20
Mushārakah Project Cost	Rs.43.083 Million
Bank's Investment	Rs.
Entrepreneur's Investment	Rs.
Period of Completion of Project	2 Years from the date of First Disbursement Insurance Insurance of Construction Portion will jointly be arranged. This was to be converted into *takāful* as and when became available.

3. Please calculate the Missing values:

TABLE 4
Sale proceeds and profit

Total Sale Proceeds received in Collection A/c.	Rs.56.465 M
Project Cost	Rs.43.083 M
Profit on *Mushārakah*	Rs.13.382 M
BOK's Profit Portion @ 60%	Rs.8.029 M
Co-Partner's Profit Portion @40%	Rs.5.353 M

4. Complete the following accounting treatment of the transactions happened in the case:
a. Customer share of investment is deposited in his account and then transferred to Investment account
Customer's Deposit Account____DR
Project *mushārakah* Investment Account __________________________________CR

....

b. *Mushārakah* Finance account is created in system and disbursement is made for Bank's share of Investment
Project *Mushārakah* Finance Account ___________________________________DR
Project *Mushārakah* Investment Account __________________________________CR

....

c. *Mushārakah* payments are paid through remittances or cash withdrawal/cheques
Project *Mushārakah* Investment Account __________________________________DR
Remittance/ Withdrawal ____CR

....

d. On each month end, profit is accrued at pre-agreed rate on outstanding balance of bank's investment

Accrued Income on Project *Mushārakah*______________________________________DR
Income on Project *Mushārakah* ____CR

....

e. Upon receipt of Sale proceeds of *Mushārakah* assets
Cash / Clearing/Any Deposit A/C ____DR
Project *mushārakah* Collection Account _____________________________________CR

....

f. If sale proceeds are to be injected back in project
Project *Mushārakah* Collection Account _____________________________________DR
Project *Mushārakah* Investment Account _____________________________________CR

....

g. At settlement/ maturity of *Mushārakah*
Project *mushārakah* Collection Account _____________________________________DR
Customer's Account____CR
Accrued Income on Project *mushārakah* _____________________________________CR

....

h. In case of Loss on *Mushārakah* at the time of settlement
Loss on *Mushārakah* (Exp)____DR
Project *Mushārakah* Finance Account______________________________________CR
Accrued Income on Project *Mushārakah* _____________________________________CR

....

5. Analyze the risks in the *Mushārakah* project financing.
6. Researchers/students may download the *Mushārakah* Investment Agreement From the website of the State Bank of Pakistan;
https://bit.ly/2W10U1l, review it thoroughly and indicate any Sharī'ah or process issues and suggest how the same could be resolved.

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