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Maneuvering the Application of Musharakah Contract on Venture Capital

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Abstract
Musharakah is a partnership contract in conducting business; based on capital and labour contribution by the investor and entrepreneur through a profit and loss sharing (PLS) agreement. These concepts are also similar to the conventional venture capital principle, which is expanding in Malaysia. According to Ibnu Arfa (1984), *Musharakah* is an agreement between two or more persons carrying on a particular business to share profits in their investments. However, the use of *Musharakah* contracts is increasingly being eroded in Islamic banking. This can be proven by looking at the products offered by Islamic financial institutions. Therefore, this study aims to explore the current application of *Musharakah* contracts on venture capital in Islamic financial institutions. It also explores the possible innovation to improve the application of *Musharakah* contracts on venture capital. Qualitative research through a systematic review of relevant literature was conducted during this study.
Keywords: Vanture Capital, *Musharakah*, Investment Company

Introduction

Shariah-compliant financial products of Islamic financial institutions may be classified into two main categories: profit-and-loss sharing (equity-based modes) and non-profit-and-loss sharing (debt-based modes). In debt-based methods, the price is fixed; and any increase is classified as *riba* (Abdul-Rahman, 2020)

The two main products in profit-and-loss sharing (PLS) modes of financing are *Musharakah* and Mudarabah. *Musharakah* is an active joint venture, while Mudarabah is a silent joint venture. *Musharakah* is a partnership contract involving two or more individuals. Each individual needs to contribute capital to run a business. In addition, the profits and losses will be borne together depending on the percentage of money issued by the individuals involved (Arfa, 1984). Moreover, *Musharakah* is a contract between two people who do financial business for profit (Khan, 1990).

However, financing based on the *Musharakah* contract is still less practised by Islamic banking in Malaysia. Based on information released by Bank Negara Malaysia (BNM) in July 2021, the number of payments based on *Musharakah* contracts was deficient, at a rate of 9.34% (table.1) of the total amount of financing offered by Islamic banking institutions.

Table 1
Islamic Banking System: Financing by Concept (RM million)

Year Ended December million	***Mushārakah* Financing**	***Mudhārabah Financing***	**Total Financing**	**% of *Mushārakah* Contribution**
2006	156.8	147.9	73,368.1	0.21%
2007	403.1	109.8	86,408.6	0.47%
2008	1,134.6	312.9	104,630.1	1.08%
2009	2,037.0	375.5	135,309.2	1.51%
2010	3,958.3	275.8	159,211.10	2.49%
2011	7,397.6	251.6	196,998.9	3.76%
2012	11,940.1	142.2	232,797.8	5.08%
2013	16,788.9	148.4	280,905.8	5.82%
2014	23,187.4	78.6	343,408.7	6.75%
2015	28,749.6	77.8	393,956.9	7.30%
2016	41,162.8	71.1	441,035.0	9.33%
2017	49,216.3	60.4	488,047.9	10.08%
2018	53,420.7	43.7	571,509.0	9.35%
2019	57,686.5	43.7	615,451.3	9.37%
2020	59,505.1	144.1	645, 595.9	9.21%
2021	64,003.7	244.4	685,584.9	9.34%

Source: BNM Statistic Department – Islamic Banking System: Financing by Concept.

The figures released by BNM show that Islamic financial institutions focus on financing products offered to institutions or contracts not based on the no-loss partnership concept, as suggested by most scholars in Islamic banking. Among them, released by Abdalla (1999), in an article entitled "Partnership (*Musharakah*): A New Option For Financing Small Enterprises?" states that *Musharakah* is a contract suitable for use by Islamic banking institutions for business financing as indicated in table 1.

High-risk investments are the main challenge in applying the *Musharakah* contract in Islamic banking. These financing concepts are difficult to implement due to their high probability of failure, resulting from various factors, such as the entrepreneurs' lack of skills and experience in the business. The concept of a partnership through profit and loss sharing could cause Islamic banks to be very cautious in providing financing through the *Musharakah* concepts (Abdul-Rahman, 2016).

In Malaysia, *Musharakah* contracts offered by Islamic banks are based on *Musharakah Mutanaqisah*. An Islamic bank offers *Musharakah Mutanaqisah* for home financing (Asadov, 2018). There are fewer studies on *Musharakah* contracts related to venture capital (Rahman, 2020). Therefore, this study aims to explore the current application of *Musharakah* contracts on venture capital in Islamic financial institutions. It also explores the possible innovation to improve the application of *Musharakah* contracts on venture capital. Qualitative research through a systematic review of relevant literature was conducted during this study.

Literature Review

***Musharakah* contract**

Musharakah is a partnership contract involving two or more individuals. Each individual needs to contribute capital to run a business. In addition, the profits and losses will be borne together depending on the percentage of money issued by the individuals involved (Arfa, 1984). Moreover, *Musharakah* is a contract between two people who do financial business for profit (Khan, 1990).

In general, *Musharakah* is divided into two major parts. The first is *Shirkah Amlak* which is the mixing of property and ownership due to certain factors without the need for a *Musharakah* contract, or we can understand that ownership of the shared property is obtained directly by *tauqifī* (based on guidance from the Prophet SAW) following the decree of Allah SWT (Warninda, 2019).

While the second form of *Musharakah* contract is *Shirkah al-'uqūd*, which is a *Musharakah* that occurs due to the will of both parties by making a joint arrangement and agreement between two or more parties on a business that can gain profit from the capital issued by the party that share (Ali, 2022).

Application of *Musharakah Mutanaqisah*

Musyarakah Mutanaqisah is a derivative product of *Musyarakah* contract, a form of cooperation between two or more parties. The root word of *Musyarakah* is *Shirkah* which comes from the word: sharakah, which means partnership. *Musharakah* or *Sharakah* is a collaboration between capital and profit from two parties, both companies and groups. At the same time, *Mutanaqisah* comes from the words; *Tanaqish*, which means to reduce gradually (Asadov, 2022).

Musharakah Mutanaqisah is a *Musharakah* stipulating that one partner's share of funds will be gradually transferred to the other partner so that his share of funds will decrease. At the end of the contract, the other partner will become the complete owner of the business (Nafi'ah, 2022).

Musyarakah Mutanaqishah (diminishing partnership) is a form of cooperation between two or more parties for the ownership of an item or asset. This cooperation will reduce the ownership rights of one party while the other party increases its ownership rights. This transfer of ownership is through a payment mechanism for other ownership rights. This form of cooperation ends with the transfer of the rights of one party to the other party. The general scheme of mortgage financing using the *Musyarakah Mutanaqishah* contract at Bank BTN Syariah Banda Aceh is as follows (Rahman, 2022)

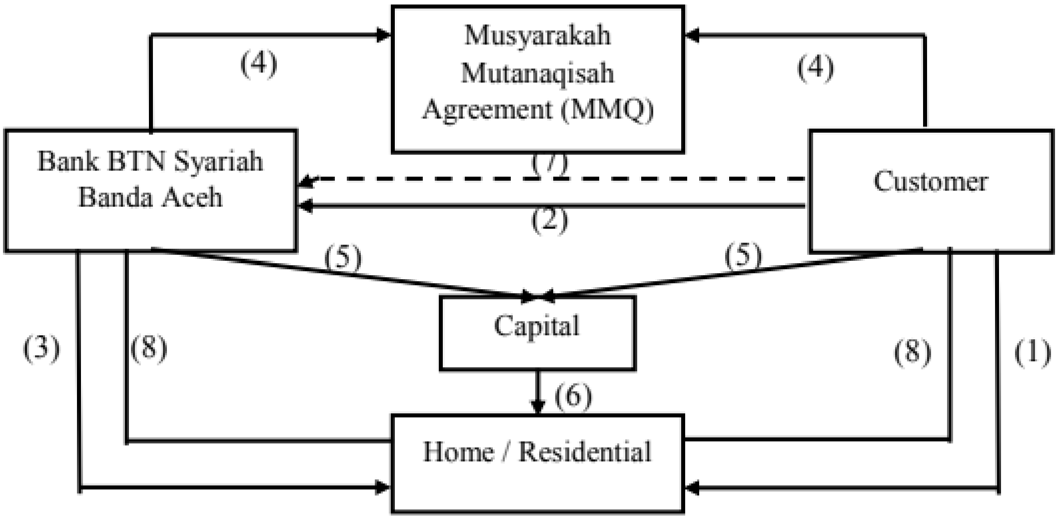

Figure 1. General Mortgage Financing Scheme

Remarks
1. Customer is looking for the desired house/occupancy.
2. The customer applies for mortgage financing;
3. The bank conducts a feasibility analysis (process and verification) of the customer's financing application;
4. The bank and the customer agree to use the MMQ contract;
5. Banks and customers jointly contribute funds/capital according to the agreement;
6. The existing capital will later be used to buy the house desired by the customer;
7. The customer will gradually purchase a portion of the Bank's ownership and pay the rent as a consumer tenant (*musta'jir*);
8. As a result of the customer's purchase, the customer's share of ownership of the asset will increase while the portion of the Bank's right will decrease.

Venture Capital
Black and Gilson (1998) define Venture Capital as "an investment made by a specialised venture capital organization in a business firm that has high growth, high risk, usually high technology that requires capital to finance product development or the growth of the company, which naturally necessarily requires a large amount of capital in the form of equity investment rather than debt." From this definition, venture capital only invests in business firms with high growth potential and usually requires a large amount of capital. It also explains that venture capital is a form of equity financing in the market. Increased risk in the chosen business firm is also considered equivalent to high return potential. A business firm is usually referred to as a start-up company.
Recklies & Recklies (2000) explained venture capital application as illustrated in figure 1. Venture capital companies will collect funds from private individuals, institutions, and companies and then consolidate them into venture capital funds. The fund will be divided into several portfolios according to the valuation and suitability considered by the venture capital company. Apart from monetary funds, venture capital companies will also provide advisory services in terms of management skills, access to the market, and business networks. It can be done by appointing a venture capital company representative to be part of the board of directors, a management consultant, or a financial advisor to a specific project.

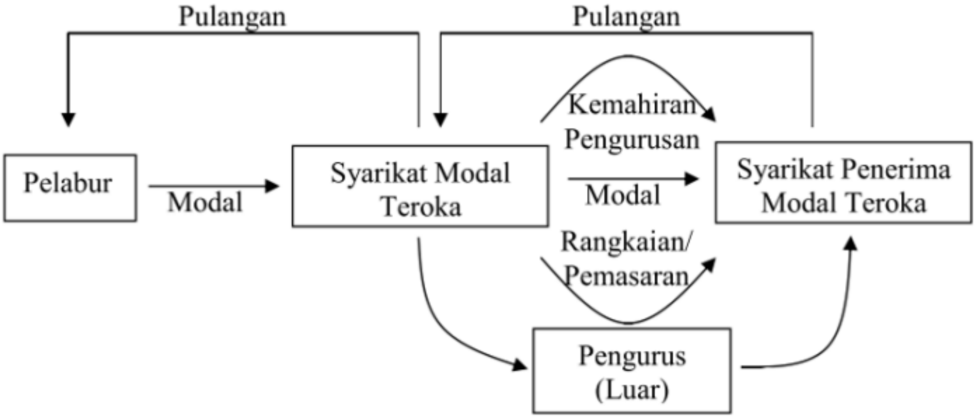

Figure 1: Venture capital model (Recklies & Recklies, 2000)

Narayansamy et al (2012) concluded that venture capital companies could provide four types of capital according to the business level: seed capital, start-up company capital, development capital, and advanced stage capital. Seed capital allows entrepreneurs to test innovative products produced; start-up capital will enable entrepreneurs to move innovation into actual business operations, whether in services or products. The growth capital will allow entrepreneurs to continue expanding their businesses to the next level. Finally, advanced-level money is to facilitate the acquisition process, divestment process, or purchase process.

Figure 3: Types of capital types provided by capital venture by business level.
Source: Narayansamy et al. 2012

Discussion and Finding

This section discusses the findings on the application of *musharakah* on venture capital. The study identified risk as the main challenge in the application of *musharakah*. Islamic banking needs to face many risks, especially in terms of capital losses.

According to the research, there are two strategies to reduce the risk in investment. The following strategies are suggested

Selecting the right partner

Choosing a partner is a challenging task. Choosing the wrong partner can cause the company to bear losses because of failure in the investment. This is an important feature to ensure that the investment can generate profit.

Partner selection can be made based on several evaluations. For example, it is to evaluate financial performance. Through this method, investment companies will usually evaluate previous records by referring to the main components, including profit and sales.

Partners with good performance can reduce the risk that the investment company will bear. In addition, this previous record is also important for an investment company to ensure that every capital investment flows to the right place.

Monitoring investment

Monitoring of partners after the withdrawal of funds should be carried out regularly. Ongoing monitoring is essential to prevent mismanagement or mishandling of funds spent and ensure that partners conduct business as described in their written proposals.

To ensure that business operations are carried out in accordance with agreed terms, the investment firm appoints company representatives as advisors to the partners. Representatives are also responsible for providing input and advice during difficult times. The representative must constantly monitor whether business operations are being conducted smoothly and report to the investment company. A site visit monitoring strategy can motivate entrepreneurs as an indication that the investment company is always ready to provide continued cooperation and commitment to the joint venture.

Conclusion and Recommendations

Musharakah is a contract that applies the value of justice to both parties. However, it is less of an option for Islamic financial institutions because Islamic financial institutions must bear a high risk when executing this contract.

The Venture Capital industry is one of the successful industries in producing businesses based on joint ventures. Through this success, we can apply the methods used by investment companies to the Islamic industry, especially through *musharakah* contracts.

The application of *musharakah* in venture capital will give many benefits to all parties. Islamic financial institutions must get out of their comfort zone by exploring new methods or ways to implement *musharakah* contracts.

The importance of this study is to see the opportunities available to introduce the use of the concept of *musharakah* in venture capital. From a theoretical point of view, this study is able to introduce the new application of *musharakah* concept through with the venture capital concept.

From a practical point of view, this new concept will lead to a positive effect on the economy. This is because most of the investments made by banks are based on financing or loans and it will lead to an increase in inflation. Therefore by introducing this new concept can restore the investment balance between financial assets and real assets. There is no denying our need to depend on investment assets, but if the amount exceeds then investment in real assets, it will pose a great threat to the economic system.

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