The Concept, Structure and Epistemological Development: Musharakah Tijariah Cross-Border Financing

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Abstract — **Musharakah Tijariah Cross-Border Financing ("Product") is the product to enable the Bank to undertake projects and contract cross-border financing activities or other identified business ventures on "pure" Joint Venture basis, using the underlying Islamic financing contract, structure and epistemological development that are expected to inject greater Musharakah concept, structure and epistemological development and also that is expected to inject greater prosper to the Bank's overall performance and ultimately able to assist small time landowners in a big way through business risk sharing. This paper also provides the link of financial access for Muslim Small Medium Entrepreneurs to Islamic venture capital as alternative financing business innovation with blockchain strategies.**

Keywords – Islamic Finance; Musharakah; Qard; Wakalah; Crross-Border Financing; Project and Contract Financing; Joint Venture; Blockchain.

I. Introduction

Islamic financing does not only focus on banking products which are deposit and financing but also extended to any investment related tools. Malaysia Islamic banking sector has initiated Islamic Financial and Services Act 2013 ("IFSA2013") to reflect the new arm under banking institution, which distinct itself from conventional practices.

The idea of introducing partnership contracts such as Mudharabah and Musharakah have created new dimension in banking. Even though they could increase the risk of banking and do not comply with Basel II and Basel III requirement, but they seem feasible in certain situation especially related to development sector. Of course, they have to be comprehensively modelled as to ensure any increase in risk could be minimized.

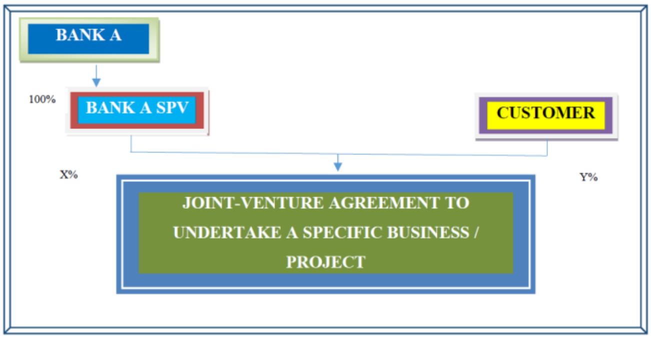
This paper purposely explores the potential of practicing Musharakah Tijaria, an underlying contract to accommodate business venture, especially between financier and entrepreneur.

II. Musharakah Tijariah

Musharakah Tijariah Cross-Border Financing uses the underlying Shariah contract of Musharakah. Musharakah literally means sharing. It is the modern term for Shirkah Al-Amwal, one type of Islamic partnership. The capital raised shall be used to finance identified business ventures that generates revenue. The profits generated shall be shared between the Bank and Customer in a pre-agreed profit-sharing ratio.

For example, Bank A as the financier through Bank A Special Purpose Vehicle and Customer will contribute capital in the project / business venture which Customer has earlier requested for funding. For example, Bank A as the financier will contribute capital in the projects / business ventures which requested by Customer earlier for funding through Bank A Special Purpose Vehicle and Customer. This joint venture can be done through Musharakah Joint Venture (JV Partners) and Joint-Venture Agreement. The capital raised shall be used to finance property development projects and contract financing or other identified business ("The Project") that generate revenue with the objective of making profit.

The simple product arrangement is shown in Diagram 1



Capital Contribution to the Joint Venture ("JV") is subjected to negotiation, feasibility study, internal policies, Board of Directors' approval and project meetings the relevant credit risk's requirements. Bank A via Bank A SPV and Customer shall regulate their relationship as the shareholders of Musharakah JV in the JV Agreement. Both JV partners shall be represented in the JV's Joint Management Committee ("JMC"). This arrangement will entail both parties jointly contributing capital in the JV Agreement. Bank A, through its Bank A SPV, will take up majority / controlling stake in Musharakah JV, with the balance to be contributed by the Customer. The purpose of this financing is to channel the funding direct to the project or business undertaking with Bank A SPV via JMC having the rights to observe and monitor regarding the business and non-business aspects of the JV.

Based on the simple product arrangement, which have been identified from this product are as follows:

A. Possibility of Having Higher Net Margin

The return from Musharakah based products is higher than those provided under the normal debt financing arrangement due to the inherent higher risk involved. The Bank shall share control over the management of the project via representative in JMC.

B. High Return

The Bank has opportunities to earn higher return through sharing of the profits as high risk and high return.

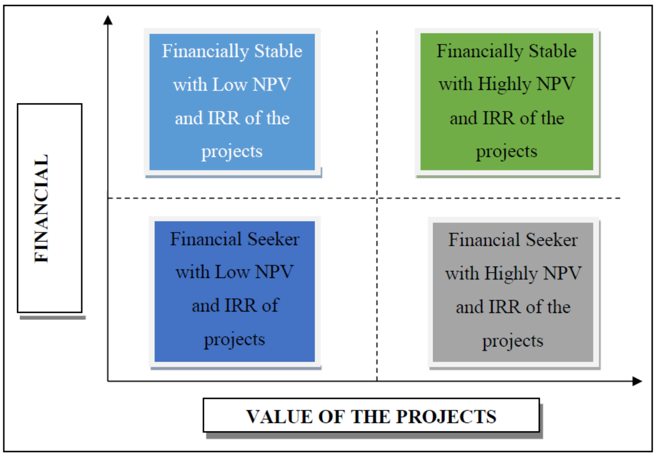
C. Minimization of Capital Leakage

Compared to the current financing arrangement where financing is extended to the owners of the business venture/projects, direct project/business financing can minimize capital leakage through active participation in the project management.

D. More Acceptable Proposition to Investors from Middle East

Musharakah provides an alternative investment, which will cater for Islamic investors and partners, especially from the Gulf Cooperation Country (GCC), who might be reluctant to invest in conventional or current debt-based financing schemes. Musharakah concept is the most preferred and globally accepted Islamic financing structure. The Bank can attract these investors to participate in similar risk sharing arrangements through the creation of Islamic syndication to support the financing made into JVs.

Since the product requires a degree of sophistication from the investors, it is intended for the product to initially, be marked to targeted groups of customers as per matrix below:



III. Risk Analysis

A. Market Risk

The most challenging issues faced in the process of the implementation Islamic financial system is the development of Musharakah instrument that can provide the investors a sufficient degree of liquidity, security and profitability to encourage their holding. Generally, Musharakah represents a position in real assets and having risk bearing characteristics whose rate of return is variable and tied to the performance of the asset is considered acceptable in the Islamic system.

- Risk Mitigation
  - Pre-emptive

    The financing (credit) paper submitted by Bank A's personnel to its internal financing approving authorities (i.e. Board of Directors) should include the project cash-flow evaluation using corporate finance approach (using Net Present Value (NPV), Internal Rate of Return (IRR), Discounted Cash Flow (DCF) valuation) to investigate its viability breakeven analysis and possible default.

  - Post-monitoring measures:

    Hedging instruments in the form of currency markets should be put place.

B. Credit Risk

In Musharakah financing, banks restrict their role in the monitoring of a company's performance without interfering too much both its partner's both management and confidentiality that do not relate to the specific joint venture project. The finance provided by banks too is also not a part of the permanent capital of a company, though there is no legal restriction for banks to finance the working capital needs of a company in the form of equity or capital participation if it is manually agreed between them. The decision whether to involve in a Musharakah arrangement with a company is based on time-honoured and prudent practices observed by banks all over the world. Efficient management, commitment worthiness and a good performance record are some of the most important criteria where a decision is normally taken.

However, in cases of new companies, banks have to exercise their good judgement. Banks may adopt different techniques in evaluating a Musharakah financing proposal. To evaluate the profitability of a proposal with objectivity, the under noted exercise will be found helpful in quantifying the profit performance of a company wishing to enter into a profit and loss sharing arrangement with a bank.

Profit sharing ratios are determined on the basis of project projections made by company in line with its previous performance or in the light of its justifiable future plans and the economic climate in general. In Musharakah, the Bank only provide funds, whereas a company or its directors besides provide capital use their enterprise, energies, skills, expertise and connections in running the business and its affairs. This aspect is given due to its consideration in deciding the profit-sharing ratios.

The drawback is that projects for funding through Musharakah are expected to be selected primarily on the basis of both anticipated profitability and the creditworthiness of the partner. The Bank's possible exposure to credit risk is also another main reason why banks are hesitant to push Musharakah.

Credit risk arises when the counterparty fails to meet its obligations on time and fully in accordance with the agreed terms. In cases of defaults in debt contracts, the Bank can easily liquidate the collateral to recover its principles, whereas in equity or capital financing of the assets and recovering returns is through the sale of its share in the project at the appropriate time.

Unfortunately, to dispose the asset at a fair price is not easy. Then, even with strong monitoring and control, the return of the financier will suffer. While the banks can sell its share either to the entrepreneur or other interested parties, one way in which the value of a firm can be enhanced by launching it in the stock market by issuing initial public offering (IPO). The latter would be possible if a well-functioning and efficient stock market exists.

C. Operational Risk

Musharakah structure is document intensive compared to conventional, tedious documentation procedures for financing disbursement, and more Shariah audits, time consuming and costlier for issuer. Musharakah in particular requires more commitments and effort from the Bank in the aspect of monitoring and supervision as the Bank assumes business as well as credit risks. Given the fact that Musharakah is equity or capital financing in character, collateral is not prerequisite. This inability to secure a lien on the assets of the business partner would require careful evaluation of the prospects of the business.

As the entire business is based on confidentiality, the client entering into Musharakah may put a condition that the Bank will not disclose any information about the business to any person without prior permission of the client. However, the extent to which Bank's Board Representative may have the access to primary and sensitive information of the invested entity would depend on whether such financing does not rank the same as a debt holder (i.e. first claimant). If the financing does not rank the same as a debt holder, given the higher capital risk exposure, the Board Representative should be allowed to access to primary and sensitive information of the invested entity, including discussion on the company's exposures with other banks.

The information system used for any cross-border financing is also major concern. The integrity and security of all data are very crucial to protect the stakeholders especially investor. This is to prevent any leak and manipulation that will create harm among contracting parties. Heading into sophisticated technology and fintech era, providing a strong operation information system is a must. Therefore, any process needs to be digitalized and protected by a strong operation system.

D. Liquidity Risk

In an Islamic bank, the security is not only needed to protect the respective customers from their inability to repay to the Bank if they unsuccessfully run their business with the funds provided by the Bank. If this happens and the security is held by the Bank, the customer's account payable could be settled through the selling security. Mismatch between the amount of money withdrawn and the completed work could happen which may lead to over spending at the end, especially if the contractor is either not using all the money for the specific project or not managing their spending properly as should, in either case the Bank must step in to rectify the situation as soon as it notices any indication of such mismatch.

The best solution for the Bank is by executing a workable drawdown mechanism that can avoid Capital Leakage. It is imperative that the Bank releases cash orders and direct payments to certain identified beneficiaries. Also, progressive monitoring of assets and liabilities in the JV for construction projects under JV can be done stringently by using the general formula as per below:

Entitlement for Current Disbursement + Outstanding Capital to be redeemed
≤ Current Deposits (payments received in Project Account and Sinking Fund)
+ Receivables (pending certification and payment receipts)

Return to the bank are more uncertain as they depend on the performance of the business; in other words, there are no guaranteed annual profits. It is risky to finance medium and long-term projects out of short-term funds. The root of these problems lies in the improper matching between the maturities of assets and liabilities in the bank's balance sheet. When there is a mismatch between the two, liquidity risks arise.

- Risk Mitigation
    - To finance assets using equity or capital financing, the liabilities need to be of long-term maturity to avoid exposure to liquidate risks. If the financial institutions can invest in assets for longer terms (i.e. equities) that are financed by long term liabilities, then the risk-adjusted profit for the bank increases.
    - As the banks deal mainly with deposits that are short term, complementarities between assets and liabilities indicate that it is just optimum (in terms of risks adjusted profits) to be use assets that have liabilities are scarce in many Islamic financial markets, most banks would prefer engaging in short-term fixed income instruments like Murabahah and Ijarah to avoid liquidity mismatch.
    - Under AAOIFI 3/1/5/14, it is permissible, based on the association or a decision of the

partners, not to distribute profit of the company from the creation of Sinking Fund. It is also permissible to set aside periodically a certain ratio of profit as solvency reserve or as a reserve for meeting losses of capital (investment risk reserve or as a profit equalization reserve).

E. Legal Risk

Various regulatory requirements will need to be met when investing directly in a business. The SPV structure will perceive benefits for Bank in terms of "Ring-Fenced" and insolvency-remoteness (such as from of the extraneous risk associated with the ownership of the asset, for example environmental liability). The Bank's liability is up to extent of its financing in the specific JV, extended via the SPV if there are liabilities arising, it would clawback to the SPV only if the SPV has given a shareholder's guarantee, and otherwise, liability will stop at the JV level. The legal documents must clearly stipulate:

- Purpose of Musharakah venture.
- Contractual relationship between parties.
- Rights, roles and responsibilities of parties to the Musharakah venture.
- Capital contributed by partners.
- Profit Sharing Ratio.
- Loss shall be borne proportionate to the capital contribution.
- Calculation methodologies and timing for profit distribution.
- Tenure of venture.
- Pricing or valuation method of underlying asset or shares.
- Reporting obligation of the Musharakah performance which include the timing and the information to be reported.
- Collateral and guarantees including rights over assets, if any.
- Terms and dissolution, termination, redemption or withdrawal of Musharakah venture.
- Fees and charges to be borne by the relevant contracting parties.

The JV Agreement should entail the rights and exclusively of each partner. It is also more important to be involved in the day-to-day management as stated in the agreement. The Bank should be watertight in governing the business, and should not just be a JMC Nominee. Thus, JV agreement should also focus on the legal perspective in Civil Law, necessary undertaking and pre-determination of default / negligence.

F. Currency Risk

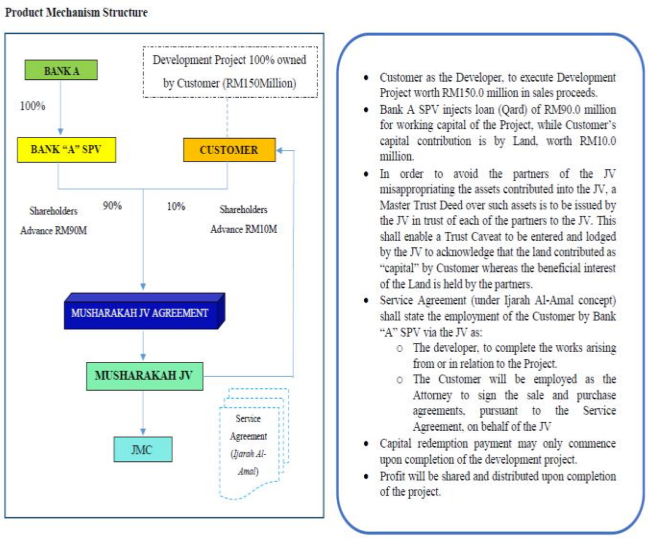
It is known that Musharakah venture has to be denominated in a single currency. Since it is a cross border financing and involved at least two types of currency, any significant movement in a currency will lead to the unmatched expectation and therefore could breach the objectives. Therefore, we need to ensure the political and financial stability of any nation involved, as to ensure the uncertain expectation will be minimized. Moreover, this Musharakah venture somehow involves in long term contract. It is good to introduce a single accepted currency or even digital currency to standardize the transaction and minimize the impact stakeholders.

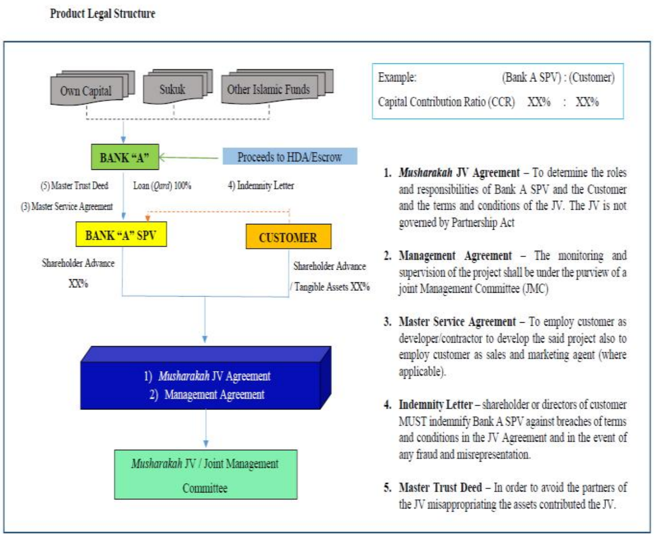
IV. POTENTIAL INNOVATION

The industry revolution 4.0 has been a theme and foundation for any future development including finance. Fintech has already been a base for financial innovation. Either financial and non-financial institution has invested extensively to mark themselves to market. Big data analytics, artificial intelligence, smart contract, block chain and distributed ledger technology are those among new dimension to be explored.

The concept of Musharakah Tijariah could benefit all these technologies to mitigate or minimize any risk associated to the product. For example, the use of block chain technology could improve the transparency of the venture, which could trace any fraud or wrongdoing. Block chain technology could also create a "special purpose currency" or "universal currency" like crypto currency to mitigate risk associated to uncertain rate of denominated currency in the venture. This could also improve the reliability of the venture, without only focusing on the conventional risk mitigation tools.

The simulation of the risk in the venture could be traced extensively using big data analytics and artificial intelligence. Any potential loss could be traced earlier than expected and any mitigation plan can take place. These could be new dimension to mitigate risk under venture business and make proposed Musharakah venture looks viable and reliable.





CONCLUSION

This product encourages mobilization of idle capital or cash entities within cross-border financing activities and thus provides a basis for economic cooperation between these organizations in the society. This product also is expected to inject greater prosper to the Bank's overall performance.

Premised on the above, Musharakah Tijariah Cross-Border Financing provided the Bank wider customer experience for markets that are still largely untapped. It also provides opportunities to expand the investment choices and opportunities available to the Bank clients and allow them to execute alternative investment strategies. Customer also may leverage on market reputation as a JV partner to the Bank especially small medium entrepreneurs.

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