EQUITY AND FEE-BASED CONTRACTS

September 2021

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OUTLINE

Equity-Based Contracts

- Musharakah (Profit and loss sharing partnership)
- Mudharabah (Profit sharing/loss bearing partnership)

Fee-Based Contracts

- Wakala (Agency)
- Kafala (Guarantee)

Benevolence Contract

- Qard al-hassan (Benevolence loan)

Musharakah

- A Musharakah is a partnership that is set up between two or more parties usually to conduct business or trade.
- It is created by investing capital or pooling together expertise or goodwill.
- Partners share profit based on ownership ratios and to the extent of their participation in the business and share loss in proportion to the capital they invest.
- Profit cannot not be fixed in absolute terms such as a number or percentage of invested capital or revenue.

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Classification of Musharakah

MUSHARAKAH (SHIRKAH)

- **SHIRKAT-UL-MILK**
  Partnership in ownership of asset for personal use
- **SHIRKAT-UL-’AQD**
  Partnership in joint business venture and trade
  - **SHIRKAT-UL-AMWAL**
    Partnership to earn profit investing in joint business venture
  - **SHIRKAT-UL-A’MAL**
    Partnership in the business of providing service
  - **SHIRKAT-UL-WOJOOH**
    Partnership where subject matter is bought on credit based on goodwill

Duration of Musharakah

- Ongoing Musharakah: Partnership where there is no intention of terminating or concluding the business venture at any point for instance equity participation. Partners may exit the business at any point they want. This is usually done by the remaining partner(s) purchasing the share of the individual exiting the Musharakah.

- Temporary Musharakah: Partnership created with the intention of terminating it at a given time in the future at which point Musharakah assets are sold and distributed along with any remaining profit on a pro-rata basis. It is used to meet working capital needs of businesses.

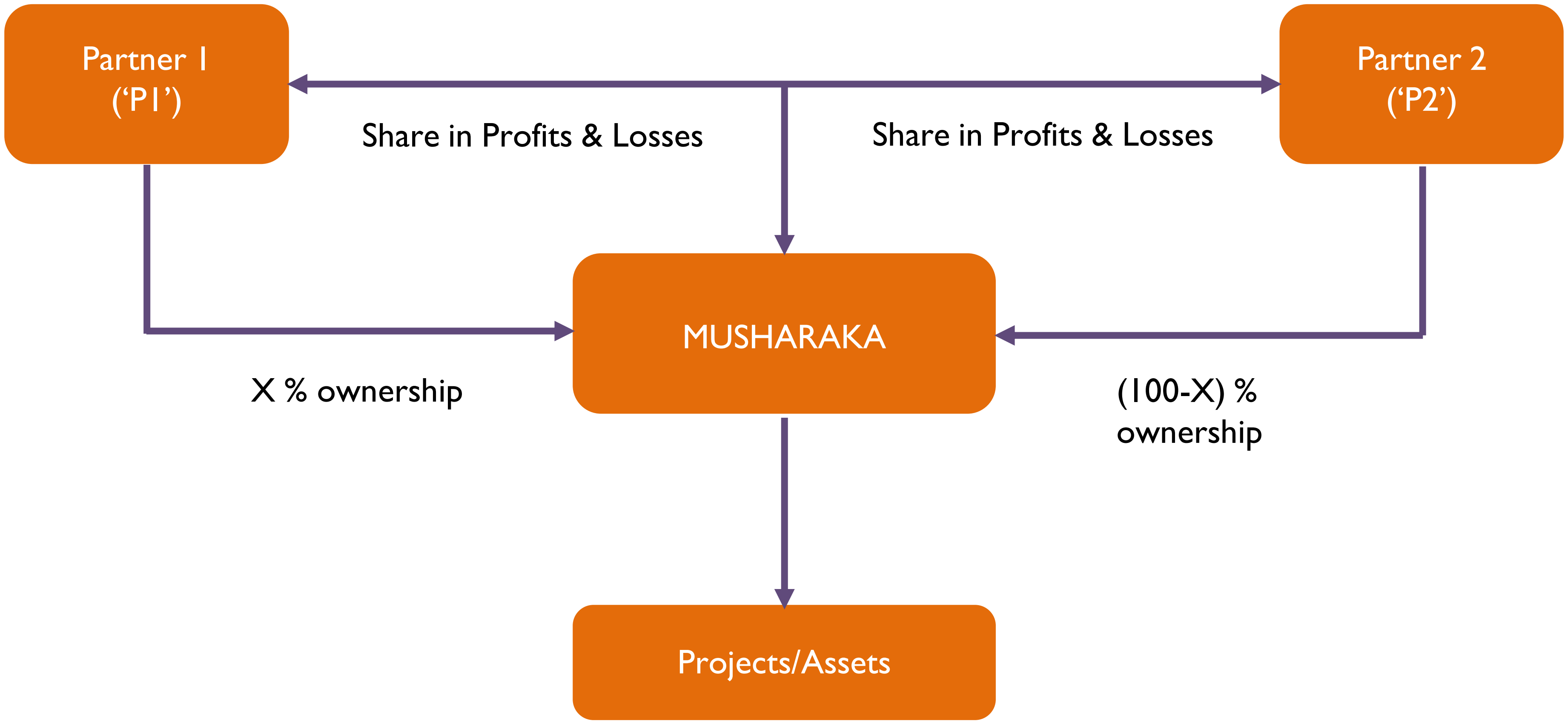
Features of Musharakah

- Musharakah capital may be in the form of cash or it may be in kind, for instance contributing assets to the business in which case it is necessary to ensure the assets are valued at the time of Musharakah execution.
- Profit may not be guaranteed or fixed in absolute terms for any of the Musharakah partners.
- Profit may not be set as a percentage of capital.
- Each partner whether minority or majority shareholder must be allocated a profit share.
- One partner cannot guarantee any part of the profit or capital of another partner.
- Silent partner’s profit ratio may not exceed his investment ratio.

Features of Musharakah

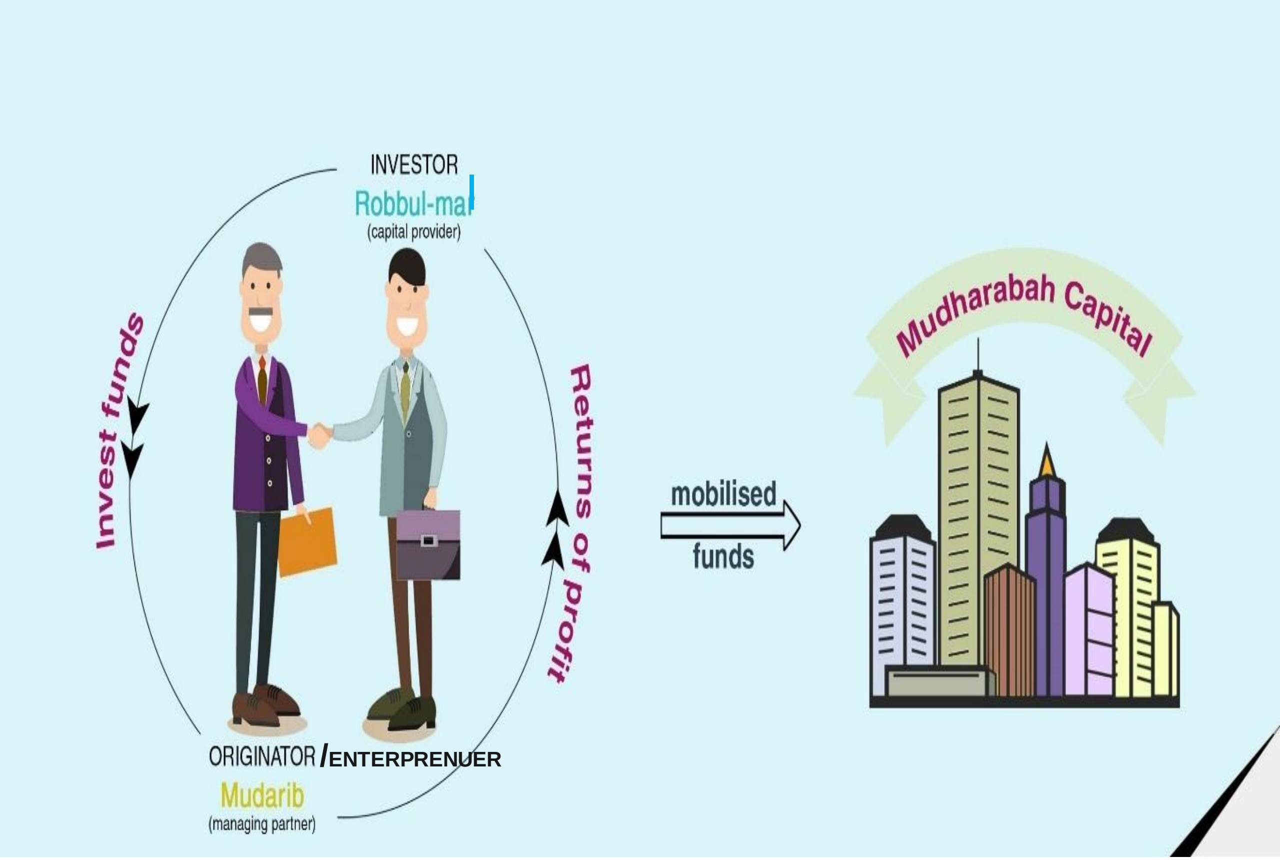
- During the Musharakah, a partner may surrender all or part of his profit share to another provided doing so is not agreed at the time of Musharakah execution.
- Profit sharing mechanism and profit ratios must be clearly determined at Musharakah inception.
- Musharakah may only announce an expected return for the business; actual returns are declared only after they are known.
- All partners are trustees of each other.
- At conclusion/winding-up of musharakah all assets/liabilities are distributed according to each partner's share in investment.
- Any change in investment shares or mergers allowed only with the permission of all partners.

Process Flow of Musharakah Transaction



Mudharabah

- A Mudarabah is a partnership between two or more parties usually to conduct business or trade.
- Typically, one of the parties supplies the capital for the business and the other provides the investment management expertise.



Classification of Mudharabah

With respect to the scope of business activity, Mudarabahs may be unrestricted or restricted.

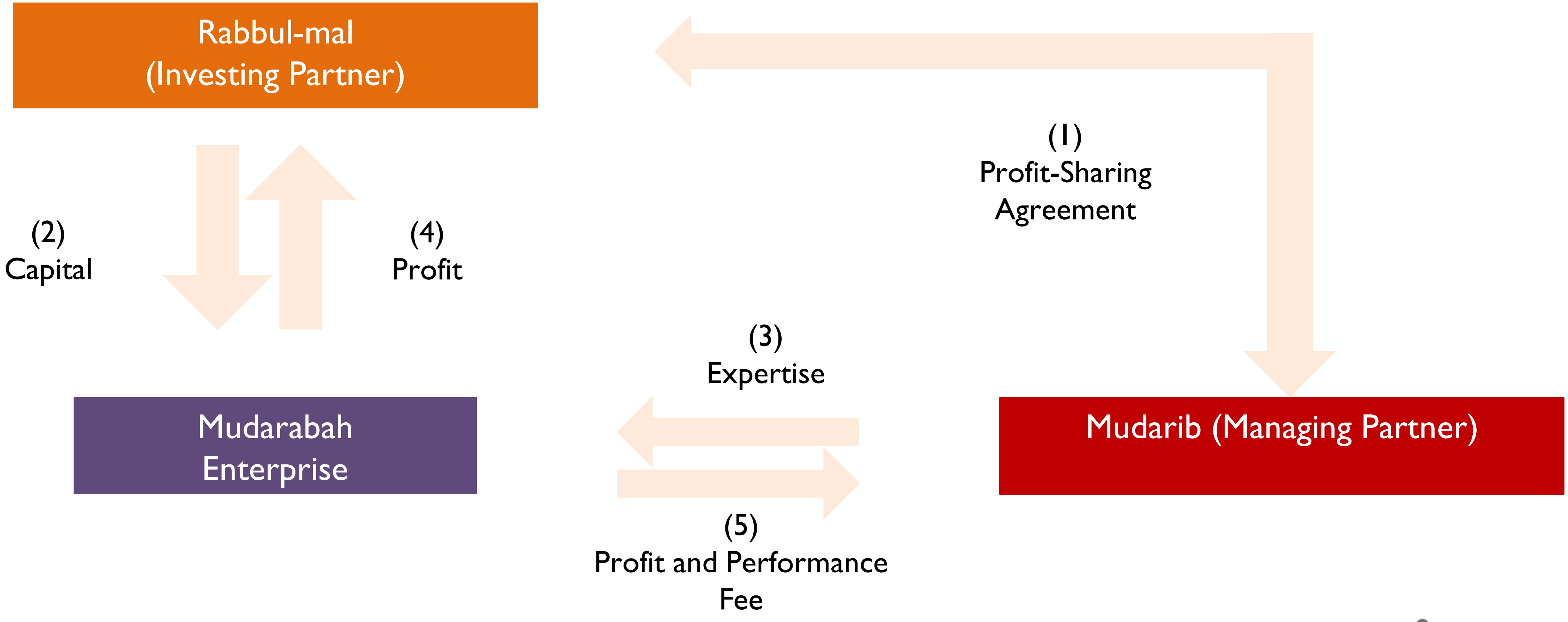
- ❑ Unrestricted Mudarabah: The Mudarib is free to invest capital in any Shariah-compliant project of his choice.

- ❑ Restricted Mudarabah: The Mudarib's investment of capital is restricted to specific sectors and activities and/or geographical regions only. Here too, all investments must be Shariah-compliant.

Features of Mudharabah

- Partners capital may be in the form of cash or it may be in kind, for instance contributing assets to the business in which case it is necessary to ensure the assets are valued at the time of Mudarabah execution.
- The capital contribution can be made by more than one Rabb al Maal. The Mudarib can also contribute capital provided that the Rabb al Maal/ Arbaab al Maal approve.
- Only the Mudarib possesses the right to manage the business. The Rabb al Maal/Arbaab al Maal serve in the capacity of silent partners.
- The profit sharing mechanism and mutually agreed profit ratios must be clearly defined for all the partners at the Mudarabah's inception or before profit or loss is generated.
- A partner may voluntarily surrender all or part of his profit share to another partner provided it is not pre-agreed at contract execution
- The Rabb al Maal/Arbaab al Maal bear(s) the entire loss based on capital contribution ratios. The Mudarib does not bear any loss except that caused by his proven negligence.

Process Flow of a Mudharabah Transaction



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Differences Between Musharakah and Mudharabah

Musharakah	Mudarabah
All partners have the right to participate in the business.	The Mudarib is solely responsible for managing the business.
All partners must contribute capital.	The Rabb al Maal provides the business capital.
All partners bear loss pro-rata to their capital contributions	Rabb al Maal bears any loss to the business provided it is not due to the Mudarib's negligence

13

Similarities Between Musharakah and Mudharabah

The Mudarib is permitted to surrender all or part of his profit to the Rabb al Maal provided it is not pre-agreed. Similarly in a Musharakah, a partner may give up his profit in favour of another on the strict condition that it is not predetermined.

FEE-BASED CONTRACTS

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Wakalah (Agency)

Wakalah is a contract in which a person (the principal or muwakkel) appoints a representative (the agent or wakil) to undertake transactions on his/her behalf, that the principal does not have the time, knowledge or expertise to perform themselves similar to a power of attorney agreement in conventional legal terms.

Parties to Wakalah Contract

There are two parties in Wakalah, namely the principal, one who delegates the responsibility on his/ her behalf, and the agent, one upon whom the responsibility is delegated. Both of them should possess the legal capacity to enter into a contract. The principal should have the right to dispose of the asset in question and the agent should be aware of his status as an agent.

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Features of Wakalah Contract

- Wakalah should be a non-binding contract. However, A wakalah contract shall be binding in any of the following situations:
  - The wakalah contract involves the rights of another party
  - The wakalah contract involves a fee (wakalah bil ujrah)
  - The wakil has commenced the work authorized to him and discontinuity of the work would cause damage to the contracting parties; or
  - The contracting parties have agreed not to terminate the wakalah contract within a specified time.
- The agent's services may include selling and buying, lending and borrowing, debt assignment, guarantee, gifting, litigation and making payments, and are involved in numerous Islamic products like Musharakah, Mudarabah, Murabaha, Salam and Ijarah.

Types of Wakalah Contracts

- Unrestricted agency (wakalah mutlaqah): It is an agency contract in which the muwakkil appoints a person as wakil to perform a particular task without any specific restriction or condition; or
- Restricted agency (wakalah muqayyadah): It is an agency contract in which the muwakkil appoints a person as wakil to perform a particular task with specific restrictions or conditions.
- Wakala without Fee: where the Bank appoint its customer as an agent to undertake transactions on his/her behalf.
- Wakala with Fee: where Customers appoint the Bank to invest their fund on agency contract for a fixed fee.

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Similarities and Differences Between Mudharabah and Wakalah

Similaries:

- In both Mudarabah and Wakalah one party is the Capital Provider and the other party is the Business Manger.
- Both Mudarabah and Wakalah could be restricted and un-restricted.
- In case of loss, both Mudarib and Wakil are not liable accept if there is no sort of negligence from their end.

Differences:

In Mudarabah, both Mudarib and Rabbul-Mal share in profit on pre-agreed profit sharing formula while in Wakalah, the Wakil is only entitled to a Wakalah fee.

Kafalah (Guarantee)

This is a contract in which a third party accepts an existing obligation and becomes responsible for fulfilling someone's liability. It is a pledge given to the creditor that a debtor will repay his debt.

In conventional finance, this situation is called surety or guarantee.

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Types of Kafalah

- **Al-Kafalah bi al-nafs**
  - Guarantee to bring someone to a specific authority, such as the judiciary.
- **Al- Kafalah bi al-mal**
  - Guarantee to return an asset to its owner
  - Can be divided into three main categories:

1. Kafalah bi al-dayn: Guarantee of repayment of another party's loan obligation.
2. Kafalah bi al-‟ayn/ kafalah bi al‟-taslim: Guarantee of payment for an item or a guarantee of delivery in a transaction.
3. Kafalah bi al-darak: Guarantee that an asset is free from any encumbrances – specific for transactions that involve the transfer of titles of rights and ensures that an asset is free from any encumbrances

Effects of Kafalah

- Once a valid kafalah is concluded, it establishes a right to the creditor to claim the debt from the guarantor. The principal debtor is not released from the debt.

- The creditor has an option whether to demand the payment of debt from the principal debtor or from the guarantor.

- Kafalah is a gratuitous contract. This means that the service rendered by the guarantor is done freely without any reward or payment. However, it is possible that a guarantor may demand a certain fee for his service.

Qard al-hassan (Benevolent loan)

Qard is a loan extended on a goodwill basis, with the debtor only required to repay the amount borrowed. It is that loan which a person gives to another as a help, charity or advance for a certain time. The repayment of loan is obligatory.

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Thank You!