

## PROMOTING ISLAMIC PRIVATE EQUITY FUND AS AN IDEAL FINANCIAL INTERMEDIARY INSTITUTION

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### Abstract

The existence of financial intermediation institution is quite necessary to support the economic activity. It serves both surplus unit and deficit unit to meet their wants whereby the former wants to invest his money in the lack of skill, while the latter wants to develop their businesses but does not have adequate capital. Bank institution is the most common institution serving the people's need of financial intermediation. However, bank has several weaknesses that may harm and hamper the economic development. This paper aims to explore the weaknesses of banks as financial intermediary institutions and then promote Islamic Private Equity Fund as alternative. The result showed that the weaknesses of banks are: 1) fractional reserve banking, 2) fiat money, 3) debt-based investment, 4) risk averse. Furthermore, the study also found that Islamic Private Equity Fund can serve as an ideal financial intermediary institution due to some strengths: 1) no fractional reserve banking, 2) equity-based investment and 3) risk taker.

**Keywords:** Islamic Private Equity Fund, bank, financial intermediary institution.

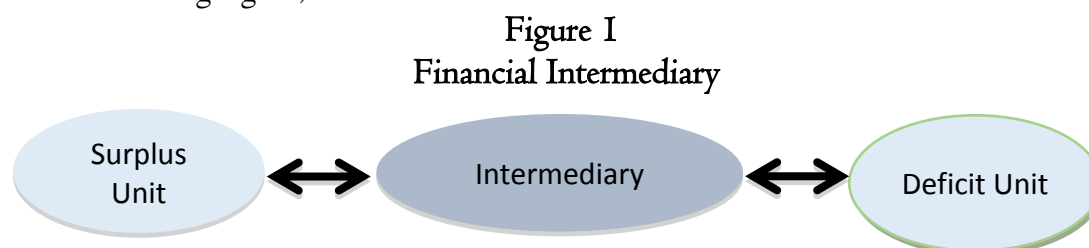
### Abstrak

Keberadaan lembaga intermediasi keuangan cukup diperlukan untuk menunjang kegiatan ekonomi. Ini berfungsi baik di unit surplus dan unit defisit untuk memenuhi keinginan mereka dimana lembaga yang intermediasi ingin menginvestasikan uangnya karena kurangnya keterampilan, yang terakhir yaitu ingin mengembangkan bisnis mereka namun tidak memiliki modal yang memadai. Lembaga bank adalah lembaga yang paling umum melayani kebutuhan intermediasi keuangan masyarakat. Namun, bank memiliki beberapa kelemahan yang dapat membahayakan dan menghambat pembangunan ekonomi. Makalah ini bertujuan untuk mengetahui kelemahan bank sebagai lembaga intermediasi keuangan dan kemudian mempromosikan Islamic Private Equity Fund sebagai alternatif. Hasil penelitian menunjukkan bahwa kelemahan bank adalah: 1) perbankan cadangan pecahan, 2) uang kertas, 3) investasi berbasis hutang, 4) risk averse. Selanjutnya, studi ini menemukan bahwa Islamic Private Equity Fund dapat berfungsi sebagai lembaga perantara keuangan ideal karena beberapa kekuatan: 1) tidak ada cadangan cadangan fraksi, 2) investasi berbasis ekuitas dan 3) pengambil risiko.

**Kata kunci:** Islamic Private Equity Fund, bank, lembaga intermediasi keuangan

## A. INTRODUCTION

In the basic circulation of fund, there are two parties who played an important part to ensure volatility in our economy. These two parties; which are from Surplus and Deficit side will continuously supply and demand the fund to achieve their objectives. For Surplus side, we can refer it to the household or high profile person who always got surplus money in their account. They always tend expect to get some reasonable return through investment. Meanwhile, there are always an entrepreneurs as well as firms who really need the additional capital to facilitate their business activities (deficit unit). They have all required skills and abilities to produce an output in economics but capital constraints sometimes would limit their output growth. The relationship of both parties can be illustrated in the following figure;



Indeed, people usually did not go directly to the money market, they prefer to go through the 'middle man' or intermediation. Due to that reasons, some institutions have been established to meet these two parties need. Since many decades ago, many financing intermediaries and instruments such as bank, insurance companies, private equity fund and pension fund try to facilitate the market as intermediaries to channel the fund from the Surplus units to the Deficit units. The bank would be the most popular intermediaries that received money from the depositors and offered some portions of that deposit as a loan as the financing assistantship to deficit parties.

However, the former financing instrument that has been offered by the conventional banks has created some problems to the overall circulation of fund. For instance, in the conventional banking, money has being made to beget money, which contradicts with Islamic teaching that treats money as medium of exchange and not as good or commodity. Islam forbids people from profiting by lending it, without accepting a level of risk. In other words, interest or 'riba' cannot be charged. Wealth can only be generated through legitimate trade and investment. Any gains relating to this trading are shared between the person providing the capital and the person providing the expertise. Other problems that will be

discussed later are the implementation of fractional reserve requirement, debt-based investment and also risk-averse from the bank.

We cannot argued anymore that the rapid development in the use of Islamic finance over the last few years is partly due to the enormous wealth and accordingly liquidity among investors in Islamic countries, who want to structure their investments in a Shariah compliant manner. As a consequence, product developers are tasked with the responsibility of creating new and innovative channels to attract these fund. The use of private equity and venture capital within a properly constructed partnership, for example, is a true manifestation of Shariah business principles that can benefit to fund the market itself.

This is key objective of this paper; we attempt to promote and encourage the Islamic Private Equity Fund as an ideal alternative in financing system. We try to zoom in into the potential and the challenges features of this Shariah compliant instrument which would contribute a huge impact to our mainstream society.

## A. WEAKNESSES OF BANKING SYSTEM

There are several weaknesses of banking system why it is not appropriate financial institution to be an intermediary:

### I. Fractional Reserve Banking

Banking systems in almost all countries operate under the fractional reserve system (FRB). FRB simply means that a commercial bank needs to keep a fraction of the deposits of its customers as reserve, while the rest can be lent out (Meera et al, 2009). The percentage of the held fractional deposit called “statutory reserve requirement (SRR) ratio”. It differs from period to period and from country to other depending on the central bank’s monetary policy.

This mechanism allows banks to create another kind of money by lending its deposits (bank money: demand deposit, electronic money). Let say a person A deposits an amount of money, say \$1000 in bank B, the \$1000 is considered as an asset for A and a liability for the bank. According to statistical tools, the bank expected that the person A will not withdraw the entire amount (\$1000) in a single particular time. Assume that the central bank impose 10% SRR, then the bank will hold a 10% as a reserve for the \$1000 deposit, the bank can extend loan as much as \$900, After money creation, the original RMI,000 deposit is now equivalent to 10 per cent of the current total deposits of RMI0,000, i.e. the required reserve ratio. This increase in money through multiple deposit creation is a one-time increase in the ‘money base’. The formula for multiple deposit creation may be written as follows: (Meera, 2010)

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$$D = I/r * R$$

D: change in deposit

r: required reserve ratio

R: change in reserve

Therefore, fractional reserve banking system also gives unfair seigniorage profit to the bank which authorized to create new bank money (Meera et al, 2010). Furthermore, the increasing of money supply will create inflation for the society. It can be understood from the quantitative theory of money:

$$M V = P Y$$

M: money supply

V : Velocity

P : Price

Y : Income

It can be interpreted that the increasing of money which is higher than the growth of income will lead to the increasing of price which means inflation. Inflation is a hidden tax for the people. On the other hand, the full reserve banking system prevents this process to occur. Because banks must hold 100% of the deposits, then there is no opportunity for banks to create new money.

Syamlan (2016) did a study about the epistemological perspective of fractional reserve banking system. He concluded that fractional reserve banking creates more mafsadah than its benefit. He suggested Islamic banks to apply 100% reserve banking system. By implementing 100% reserve banking system, the implications caused by fractional reserve banking system that discussed earlier; seigniorage, inflation, will disappear in the economy system.

Ascarya (2015) explored the real causes of financial crisis in Islamic economic perspective. He found that one of the causes is the fractional reserve banking system. He further explained that this system creates an unstable monetary system.

### 2. Fiat Money

Fiat money is a tautological abstract representation of government promises of value. To be sure, a fiat money is simply a piece of paper that is artificially and arbitrarily imbued with value—and thus accepted as a mode of exchange and store of value—because a government body asserts its value through law, and It is not backed by any real asset such as Gold, or any commodity. This brings the issue of seigniorage, which is the benefit one gets from the first use of fiat money, i.e. the

free purchasing power which new money, not backed by gold or anything with intrinsic value.

Within an economic system where fiat money is used, the institution given the authority to issue money (usually central bank, monetary authority, treasury department, or other appointed institution) gains this seigniorage benefit. Therefore, the average purchasing power of money will reduce according to the new money added in the economy, and it will affect all classes, while fixed income people are more affected.

However, money in Islam is completely different. It is either in the form of gold or silver, which has intrinsic value equivalent to its nominal value, or in the form of paper or coins, which its nominal value is backed by real assets; either Gold or any other commodities which have the characteristics of money (fully backed money). In this system, there is no new purchasing power created by creating money (no inflation). So, generally the Islamic economic system tends to be stable, and doesn't face inflation. Since the value of money is real, the institution that issues money doesn't gain benefit from seigniorage. But still has charged the cost of issuing.

Ascarya (2015) also emphasized the negative impact of fiat money as it may cause unstable monetary system that leads to a financial crisis. Furthermore, Meera (2010) argued that fiat money also the main factor of money speculation and arbitrage. The current economic system of fiat money which is volatile in nature allows the speculators and arbitrage to make huge profit. Therefore, he introduced a form of money which avoids those problems. The form is gold-based electronic interest-free credit as money. In this proposed system, everybody can get money freely without borrowing at interest since monetary system is only an information system (Meera, 2009b).

### **3. The dominance of Debt-based Investment**

The problem with debt financing is that the debtor should pay a fix periodic payment, while the cash flow of business is not fixed. Hence, business bears risks higher than the debt itself. In this current system, debt-based investment is widely used in the whole sectors. Government as well as entrepreneurs has no enough alternatives to get capital other than debt since money grows in the form of debt. They will become indebted until they cannot bear anymore to pay it back. Consequently, government and firms will collapse. What happens in the Greece today is the example for the government who fails to pay back the debt, while Enron and Xerox are the example or the collapsed firms. (Meera, 2009a)

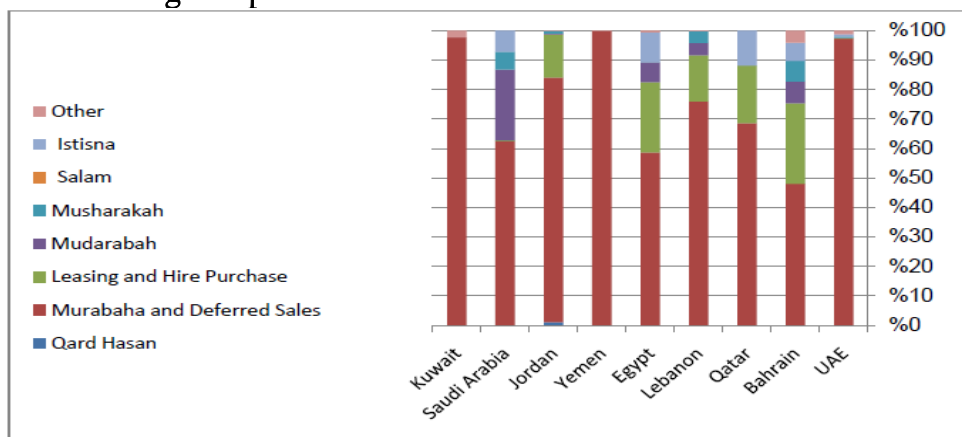
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Islamic scholars may opine that those problems occurs because of interest on debt. The prohibition of interest as it is similar to *riba* which is prohibited in Shariah, encourages Muslim scholars to establish an Islamic bank which is free from interest. There is a hope that Islamic Bank will be able to be a fair financial intermediary institution, since the basic concept in Islamic banking is profit and loss sharing.

In its early phase, it was proposed that Islamic banks will adopt profit-sharing contract of financing (*muḍarabah* and *mushārah*). However, the experience shows that Islamic banks prefer to use fixed-income contract in financing such as *murabahah* and *ijarah*. It can be seen in the following table that the proportion of *murabaha* in total financing of MENA (Middle East and North Africa) Countries is 75%. The second widely used contract is *Ijarah* contract whereby it may also categorized as debt-financing investment.

Figure 2  
Financing composition of Islamic Banks in the MENA countries



Source: Ali, Salman Syed (2011), Islamic Banking in the MENA region, IRTI-IDB

Chapra opined that the using of debt-based instrument may not conform to the true spirit of Islamic principle as the agreed profit margin being no more than a trick for interest. Even though, he is also of the view that the nature of those debt-contracts are allowed in Islamic point of view (Chapra, 1985). Likewise, Mirakhor (1997) stated that debt-based investment cannot be treated as un-Islamic contracts, because it is absolutely allowed in Islam. However, he admits that from an economic point of view, profit-sharing mechanism has more advantages that are not obtained in debt-system. He argued that debt-based system always has to limit itself to short term investment and trade transaction. This system, according to

him, can hamper the process of capital accumulation and thereby economic development and growth of economy. Islamic banking should perform its important role as financial intermediation that can lead the economic growth by using long-term equity financing.

A survey on Islamic modes of financing reported that the primary reason of financiers to avoid the using of equity financing is the apprehension that entrepreneurs will be dishonest in reporting the actual figures of their profits.<sup>1</sup> Despite of that, Ahmad argued that banks have been avoiding equity financing due to organizational structures of banks that do not provide all the factors needed for equity financing. *First*, In equity-based financing, the liabilities need to be long term maturity in order to avoid liquidity risk. Moreover, he analyzed that risk-adjusted profit will decrease when financial institution invests in assets that have long-term maturity with short-term liabilities. Indeed, most of banking funds are obtained from saving, where the depositor may withdraw his money at any time.

*Second*, managing the credit risk; financial institution using equity financing should monitor and control the assets in order to solve moral hazard problems and ensure the investment will earn return. Moreover, the availability of the means by which the financial institution is able to dispose its share in the project is also needed for equity financing. *Third*, regarding the operational risk whereby institutions that use debt-based instrument will require the basic banking skills to deal with managing mainly financial risks, while equity financing requires comprehensive knowledge of managing both financial and business risks. However, these comprehensive skills are costlier than basic skill as a variety of expertise is required in the former than in the latter. (Ahmed, 2005)

The fact shows that most of deposits in Islamic banks are essentially of short-term maturity. The dominance of equity-based financing will increase their liquidity risk and also their profits. Furthermore, Islamic bankers do not have the comprehensive skills to evaluate, monitor and control the assets. This increases both the operational and credit risks. Thus, the use of equity financing under the current operational format increases the overall risk of making the return from investment uncertain. Given the nature of liabilities and banking skills of the manager, the optimum strategy for Islamic banks is to use debt instruments. Hence, it can be concluded that banking including Islamic banking will always minimize their equity financing.

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<sup>1</sup> in a survey of 23 banks, Khalil, Rickwood, and Murinde (2002) found that misreporting the outcome by the agent is the prime reason that prevents banks from adopting mudarabah financing contracts

#### 4. Risk Averse

Risk aversion is a concept in psychology, economics, and finance, based on the behavior of humans (especially consumers and investors) while exposed to uncertainty. It is a description of an investor who, when faced with two investments with a similar expected return (but different risks), will prefer the one with the lower risk. A risk-averse investor will always try to avoid the risk even though it will probably give him more benefits. He dislikes risk, and therefore will stay away from adding high-risk stocks or investments to their portfolio and in turn will often lose out on higher rates of return ([www.investopedia.com](http://www.investopedia.com)). For instance, an investor who is more preferred to deposit his money into bank account which offers low return than to invest in stock market which offers high return but also has a chance of loss is categorized as a risk-averse investor.

In the case of banks, conventional banks lend their money to the deficit unit at interest without having any care about the condition of the borrower whether he earns profit or suffers loss. Banks only want to get the debt-payment back with interest. They averse the natural risks of business that will not generate profit overtime by asking guarantee that the loan money will be returned back. Similarly, most financing of Islamic banks is debt-based investment which means that Islamic banks choose to invest using *murabahah* and *ijarah* that offer medium rate of return than to invest using partnership contract that may give him a higher profit. However, since Islamic banks behave risk aversion, hence, it is preferred to use *murabahah* contract that offers a certain return compared to profit-sharing contract that has a probability to suffer losses.

Moreover, Banks are not going to invest in the new industry such as technology development that has high return in the future as well as high risk. Likewise, they will not finance the small and micro industry. They select the firm or entrepreneur that has good record rather than investing in the new firm or entrepreneur that they are actually in the need of capital. Indeed, new industry, small and micro industry should be supported in order to develop and grow the economy.

Collateral requirement in the financing is also an indicator that banks always try to minimize even to eliminate their risks. In fact, it is required to mitigate the risk to the debtor. Consequently, banks do not bear any risk even when the case of default comes as the bank may take the collateral. Here, it can be said that debt-based investment is often used due to minimize but eliminate the credit risk. In the end, banks will prefer to give financing for borrower or entrepreneur who can offer high profit and better marketable collateral.



To conclude, Banks including Islamic banks are behaving risk aversion. This behavior is caused by their obligation to return back the depositor's fund when they want to withdraw it whereby most of fund in banks are deposit fund as depositors will not bear any losses. Risk aversion of banks will hinder the growth of economy.

### C. ISLAMIC PRIVATE EQUITY FUND

It is clear from the above discussion that banks are not appropriate financial intermediary institution since they may cause several negative effects as mentioned. Hence, in this section, authors will promote Islamic Private Equity Fund as a better financial intermediary institution compared to the banks.

#### I. Introduction to Private Equity Fund

Referring to Investopedia, PE consists of investors and fund that make investments directly into private companies or conduct buyouts of public companies that result in a delisting of public equity. Capital for private equity is raised from retail and institutional investors, and can be used to fund new technologies, expand working capital within an owned company, make acquisitions, or to strengthen a balance sheet.

In general, PE is also called as Venture Capital (VC). The distinction between them is not easy to make. Technically, VC is a private source of financing for high-risk business endeavors. It is one financing alternative among many sources of capital that are available to growing companies. VC is generally invested in equity ownership of a company or new venture. The investment is usually in the form of stock, or sometimes in the form of a convertible debt, which is a loan that becomes a stock holding at some point. Offsetting the high risk the investor takes is the promise of a very high return on investment. (Burril et al, 1988)

From the explanation above, it can be derived that PE (or VC) has specific features which are:

- PE is equity based financing
- The shares of PE are not selling in capital stock market
- PE is long term investment
- PE needs large amount of money to invest
- PE is limited partnership
- PE offers huge return but expose to high risk of investment
- The firms which are structured by PE capital are not listed companies

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Private Equity fund is a collective investment scheme of individuals and institutions in a portfolio of target companies that structured by the investment managers.

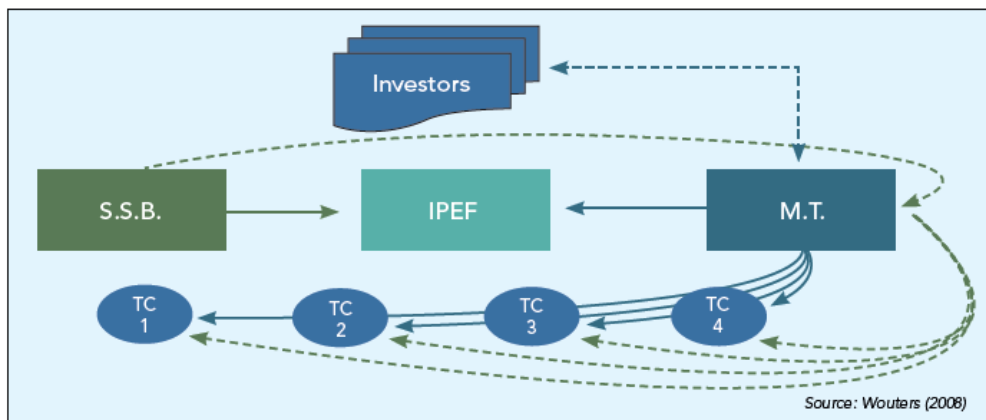
### 2. Structure of IPE Funds

In PE firms, there are only two components as partnership:

- The General Partners (GP): The Management Team that will select where to invest the funds, manages the target company, and thinks the exit strategy
- The Limited Partners (LP): The provider of funds.

In IPE funds, there is an additional player: Sharia Supervisory Board. They will control the IPE funds to always comply with sharia. Any investments must be agreed by SSB before the decision. To have a better understanding, see the figure below:

Figure 5  
IPE Funds Structure



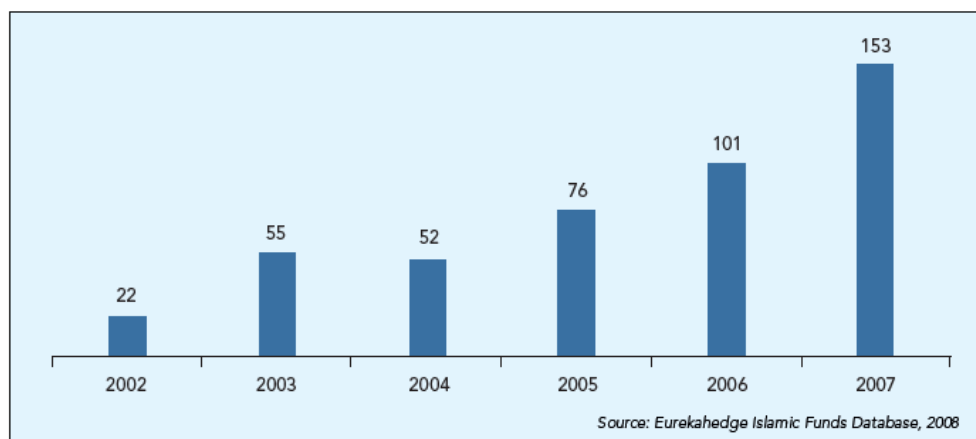
1. Sharia Advisor (SA) of Sharia Supervisory Board (SSB) sets the sharia policy to maintain the activities complying with sharia.
  2. Investors finance the IPE funds.
  3. Management team (MT) invests in the target company on behalf of the IPEF. MT should select the more profitable target companies.
  4. SSB monitors the activities to ensure that it comply with their sharia policy.
  5. MT and Sharia compliance officer (SCO) monitor the target company for the IPEF. Any sharia non-compliance will be reported to the SA.
  6. MT keeps the investors updated on the development of target companies.
  7. On the decision of IPEF, the MT will execute the exit strategy from the investment through IPO or sale.
  8. The profit or losses derived from the exit will be distributed to the investors.
- (Wouters, 2008)

### 3. Comparison between Conventional and Islamic Private Equity Fund

Usmani defined the Islamic Private Equity (IPE) Fund as an institution allows the pooling of investors who can be high net worth individual (such as retired managers) or business families, corporation and institution in order to diversify their investments and raise capital in exchange to earn high return. When the investors are operating together, they may have lower risks than being a single investor. IPE fund have to comply with sharia which is the main point distinguishes IPE to the conventional Private Equity. (Wouters, 2008)

In fact, the Islamic financial transaction has been started before 14<sup>th</sup> century but without institutions such banking or PE financing. The development of Islamic finance in general and Islamic Private Equity (IPE) is delayed by the long colonialism in Muslim countries. The first IPE appears in the last decade. The first IPE fund has existed since 2002, according to Eurekahedge Islamic Fund Database. Its number increases from year to year (see figure below). (Chatti & Yousfi, 2010)

**Figure 4**  
**The Number of IPE fund between 2002-2007**



Despite its young age, the high demand from Middle East has attracted many companies to take part in the development of IPE. It is estimated that the volume of fund will rise until \$41 billion while the fund raised in 2008 were almost \$28 billion. This rapid development was the main reason of International financial centre to establish benchmarks such Dow Jones Islamic Market index in New York and the FTSE Global Islamic Index in London. (Chatti & Yousfi, 2010)

There are several criteria distinguish IPE to the conventional: Modes, target company, aim or purpose and supervisor, guarantee, and risk. In conventional, PE institution is allowed to invest either halal and haram industry, the purpose is merely maximizing profit, shariah supervisory is not necessary, riba is permissible

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and part of income sources, and some time guarantee of capital is required by investor. In contrast, Islamic PEI cannot enter to the haram industry, shariah supervisory is compulsory, do not allow any riba based income, the purpose is not only profit motive but also public interest (maslahah) and capital is not guarantee unless in the negligence or misconduct.

Finally, Islamic PEI carries profit and loss sharing (PLS) investment. It is a real collaboration between capital and labor on the grassroot level. That is generally what the islamic economy will to do, and specifically it is the purpose of *muḍārabah* and *mushārahah*. It can use the pure *muḍārabah* or *mushārahah* contract. However, investing in the modern era will lead to the use of different form of PLS, but still under Shariah compliant.

**Table I**  
**The Difference between Conventional and Islamic Private Equity**

Criteria	Conventional	Islamic
Modes	Partnership-shared risk and reward	<i>Mushārahah</i> or <i>Muḍārabah</i> -shared risk and reward
Target Company	All Industries	Sharia-compliant Industries
Aim or Purpose	Merely profit-oriented	Not only profit oriented, but also social oriented
Supervisor	No sharia bord	Has sharia bord
Guarantee	Give guarantee for any loses	Do not guarantee for any loses

Source:Chatti & Yousfi (2010)

**a. Strength of Islamic Private Equity Fund**

There are some reasons why Islamic Private Equity Fund can be considered as an appropriate institution for financial intermediary functions:

**1) No Fractional Reserve System**

Fractional reserve system does not exist in this institution, since the investor cannot withdraw their investment fund unless at its maturity. In this case, IPE institutions are not creating the invested money, because they actually invest on the target company on the behalf of investors whereby their fund are locked for long period of time.

**2) Equity-based Investment**

Equity-based investment has a greater effect to the economic growth compared to the debt-investment. Siddiqie(2009) argued that a profit-sharing system or risk-sharing system will be more efficient and equitable compared to the risk shifting (debt) in terms of their impacts to the economy. It will create economic efficiency due two reasons: 1) investment fund will be allocated properly based on the expected profitability, 2) risk sharing encourages entrepreneurs and innovators to develop their productivity where those entrepreneurs and innovators are factors for the economic growth. Besides, risk-sharing may distribute the income and wealth properly. Profit as well as loss will be distributed equitably based on their agreement. So, each party will not be suffering loss alone as well as one party does not earn any profit when another party is suffering loss. Meanwhile, in debt financing, the debtor should pay back his debt to the creditor even he bears losses.

Since equity-based has more advantages than debt-based investments, an appropriate institution is needed. Ahmed studied the operational structure for islamic equity finance. He found that the organizational structure of venture capital is more appropriate model for minimizing the risk involved in equity financing. He argued that since the fund of venture capital are locked for long period of time, IPEF has a minimum liquidity risk. Moreover, the position of IPEF as active partnership may reduce the credit risk. However, he stated that the growth and success of equity-based institution depends on the availability of capable human resource who able to manage the risk. (Ahmed, 2005)

Sapienza(1992) held a survey in early part of 1988 to 51 match pairs of entrepreneurs and venture capitalists. The results showed that the assistance of venture capitalists may increase the added value of the company. Moreover, he concluded that “*the provision of money alone appears to play a necessary but far-from-sufficient condition to promote economic growth and resilience; evidence is mounting that venture capitalists do add value*”. It means that venture capitalist may increase the added value.

In IPEF, the modes of contract are equity-based investment contracts. There are three modes of contract used in IPE: *Mushārahah*, *Muḍārahah* and *Wakālah*.

#### ***Mushārahah***

The term of “*Mushārahah*” is commonly used in the contemporary jurist, while classical Islamic jurists use the term “*shirkah*”. *Shirkah* is a contract between two partners (*Mutashārikayn*) in the capital and profit.<sup>2</sup>The *Mushārahah* legitimacy is established based on the Qur’an, Hadith and ijma’ (consensus of Muslim scholars).

According to AAOFI (Accounting and Auditing Organisation for Islamic Financial Institutions), *Mushārahah* is

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<sup>2</sup> Hanafi school’s definition. Sayyid Sabiq, *Fiqh al-Sunnah*, Syirkah Manar al-Dauliyah, Vol. 3, p. 350

*“A form of partnership between an Islamic bank and its clients whereby each party contributes to the partnership capital, in equal or varying degrees, to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and is owed his due share of profits. However losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.”*

Above term is also applied to the *Mushārah* in Islamic Private Equity. In addition, the term also indicates that there are two types of *Mushārah* due to the ownership: a) constant *Mushārah*, which the partners' shares in the capital remain constant throughout the period, as specified in the contract, b) Diminishing *Mushārah*, which an Islamic private equity fund agree to transfer its share gradually to the other partner. Hence, the IPEF' share declines and the other partner's share increases until the latter becomes the full owner.

### ***Muḍārah***

According to Al-Zuhayli, *muḍārah* is a part of *shirkah*. Ahlu al-Hijaz called it as *Qirād*, because the owner cut a piece of his wealth to be managed to give him some profits. *muḍārah* is a special kind of partnership where one party gives money to another for investing it in a commercial enterprise. The income earned should be distributed according to the agreed ratio. The person who invests his money is called “*Rab al-māl*”, while the partner who manages the investment and be responsibility of it is called “*Muḍārib*”.

Usmani(1999) noted some difference points between *Mushārah* and *Muḍārah*:

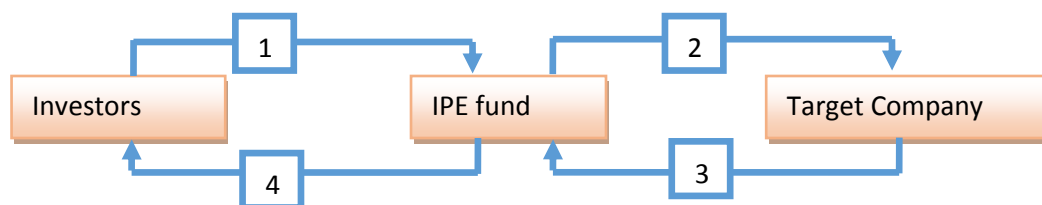
1. The capital of investment in *mushārah* comes from both partners, while in *muḍārah*, investment is the sole responsibility of *rab al-māl*.
2. In *mushārah*, all partners may participate in the management, while in *muḍārah*, *rab al-māl* has no right to participate, which is only carried out by *muḍārib*.
3. In *mushārah* all the partners share the loss to the extent of the ratio of their investment while in *muḍārah* the loss, if any, is suffered by *rab al-māl* only, because the *muḍārib* does not invest anything. His loss is restricted to the fact that his labor has gone in vain and his work does not give him any profits. However, this principle is subject to a condition that the *muḍārib* has worked with due diligence. Any negligence or dishonesty and misconducts of *muḍārib* will force him to be liable for the loss.

4. The liability of the partners in *mushārah* is normally unlimited. Therefore, if the liabilities of the business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne by all the partners. However, if all partners have agreed that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. In the contrast, in *muḍārah*, the liability of *rab al-māl* is limited to his investmen, unless he has permitted the *muḍārib* to incur debts on his behalf.
5. In *mushārah*, as soon as the partners mix up their capital in a joint pool, all the assets of the *mushārah* become jointly owned by all of them according to the proportion of their respective investment. Therefore, each one of them can benefit from the appreciation in the value of the assedts, even if profit has not accrued through sale. Meanwhile, in *muḍārah*, all the goods purchased by the *muḍārib* are solely owned by the *rab al-māl*, and the *muḍārib* can earn his share in the profit only in case he sells the goods profitably. Therefore, he is not entitled to claim his share in the assets themselves, even if their value has increased.

### Wakalah

Wakalah is a contract which gives the power and rights to another party or parties to act on his behalf, based on the agreed terms and conditions (Security Commission, 2008). Al-Zuhayli revealed that the *wakīl* or agent may get the fee of doing its agency. He argued that Rasulullah peace be upon him ever send his ‘*ummāl* or several ‘*āmil* to collect zakah then give them a commission. In this case, the agent is treated as employee that has the right to get a fee. Even though, the party may not give fee to the agent when the agent or the custom does not require it. In this case, the agent did *ta’awun fi al-khoir*.

**Figure 6**  
**Modes of Contract in IPEF**



Source: Author's property (2011)

## Promoting Islamic Private Equity Fund As An Ideal Financial Intermediary Institution

(Nashr Akbar<sup>1</sup>, Muhammad Haeikal<sup>Y2</sup>)

1. There are 3 modes of contract between investors and IPE fund: *Muḍārabah* (investors as rabb-ul-maal and IPEF as *muḍārib*), *Mushārah* (join in the capital to invest in the selected target company), and *wakālah* (IPEF as *wakīl* or invest on behalf of investors).
2. IPE fund invest in TC. There are also three modes can be used: *muḍārabah* (investors as rabb-ul-maal and TC as *muḍārib*), *mushārah* (join in the capital between IPEF and TC), and IPEF on behalf of investors invests in TC by either *muḍārabah* or *mushārah* (*wakālah bi al-istitsmar*).
3. Profit and loss sharing between IPE fund and TC. By *muḍārabah*, profit is distributed at an agreed ratio, while loss of capital is borne by *rab al-māl* (IPEF) and TC has no return on his work. By *mushārah*, profit and loss is shared among them at an agreed ratio.

In *muḍārabah*, profit is distributed at an agreed ratio, while loss of capital is borne by *rab al-māl* (investors) and IPEF has no return on his work. In *mushārah*, profit and loss is shared among them at an agreed ratio. Moreover, IPEF may gain fee if he stands as *wakīl* and sometimes earn an additional profit when he achieved more than profit required by investors.

### a. Risk taker

Economic activities are not free from risk. Some activities or business have low risk and some of them have medium risk and high risk. All those businesses should be supported by enough capital to run and develop their business. The financial support will increase their productivity and then will increase the economic growth. Unfortunately, Banking institutions are only supporting those activities that have low risk or medium risks. They do not want to finance the high risk business, whereas those entrepreneurs have important factors for the economic development.

It is well known that most of people in the developing countries are working in the small and medium Enterprises. They have important roles to increase the people welfare as well as increase the growth of economy. Nevertheless, since most of them are not bankable due to the absence of collateral, they do not get financial support from the bank. In the bank perspective, the absence of collateral results high credit risk. Likewise, invention and innovation are the main factors for the economic development. However, Banks are not interested to invest in those areas since they have high risk.

In the contrast to the bank, IPEF is a risk taker. They invest in the high risk projects with the high return. They do not ask collateral for the investment but



actively participate in the activities of the firm In order to mitigate the moral hazard and other problems. Compared to traditional banks that always resolve the credit risk through debt contracts backed by collateral, venture capitalists resolve the risk by engaging firms in a more direct and comprehensive way. One of cases proving the role of venture capital in innovation industry is in the early 1980 their financing to the American companies to license the patent of American universities. (Cizakca, 2010)

#### 4. Challenges for Islamic Private Equity Fund

There are three challenges for Islamic Private Equity Fund:

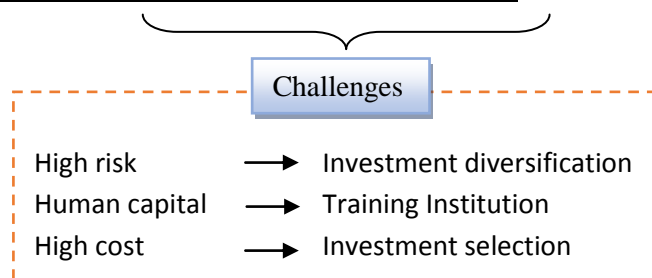
*First:* high risk investment. As explained that IPE fund behaves risk-taker. It may invest in a start-up industry, technology invention and etc whereas those businesses have high risk and high return. To manage this risk, IPEF should diversify their investments in many places. Investment diversification can minimize the risk; although some investments failed, they still may earn profit from other investments.

*Second:* Operational risk in terms of human capital risk will exist. In equity-based investment, venture capitalists are required to have more comprehensive skill compared to the bank. They should have skills and knowledge to manage both financial and business risks. The failure and success of IPE funds depend on the availability of human capital (Ahmed, 2005). Hence, training institution should be able to supply these human resources.

*Third:* High cost for monitoring and controlling the asset (investment). Therefore, they are required to investigate the quality of the target company to generating profit before investment.

**Table 2**  
**Summary**

Bank	Islamic Private Equity Fund
Fiat money	Fiat money
Fractional reserve banking	No fractional reserve
Debt-based investment	Equity-based investment
Risk-averse	Risk-taker



## Promoting Islamic Private Equity Fund As An Ideal Financial Intermediary Institution

(Nashr Akbar<sup>1</sup>, Muhammad Haeikal<sup>2</sup>)

### B. CONCLUSION

Intermediary institution is necessary to support the economic activities. Unfortunately, bank as financial intermediary has many weaknesses: fractional reserve banking, money creation, debt-based investment and risk averse. Islamic private equity funds should be promoted as an ideal alternative to facilitate the need of intermediary. The strengths of this institution are: no fractional reserve banking, equity-based investment and risk taker. However, fiat money is still a problem, since it is a monetary policy which is decided by government. Furthermore, there are two challenges of this institution: high risk, availability of human capital and high cost. Hence, investment diversification, training institution and investment selection are needed to overcome these challenges. The success of Islamic Private Equity fund depends on their managements to solve these challenges. In addition, IPEF alongside free interest system and gold based system will form an ideal economic system that may create welfare for people and eliminate injustice economic system. *WallahuA'lam.*

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