RE-EXAMINING THE STRUCTURE OF FIRMS AND THE PROVISION OF FINANCE /THE CASE FOR ISLAMIC PARTNERSHIPS

BY

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A dissertation submitted in fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance)

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AUGUST 2019

ABSTRACT

Previously, prior to the onset of banking and the provision of debt finance, debt was an exception and not the rule. Muslims used loans as an act of charity through *al-qarḍ al-ḥassan* and never expected profit out of a loan. Instead, partnerships were the main source of private equity finance and were significant in the Muslim world since the prophet (pbuh) time and even before. And while Muslims relied on *muḍārabah* and *mushārakah*, in the Medieval Europe they were using *commenda* and *societas* for their investments which are equivalent to *muḍārabah* and *mushārakah*, respectively. But with the emergence and evolution of banks followed by corporations the whole financial system was altered, and the role of partnerships started to shrink, while banks became the main provision of debt finance and corporations are the main demanders or borrowers. On the other hand, partnerships were often combining capital and labor. Accordingly, many issues started to arise. For instance, there is no consensus among scholars and economists up until today on how banks work internally and whether they have the ability to create money. They adopted three different theories and each one is based on different understanding of how banks and money function and leads to totally different economic and policy implications. Moreover, corporations' structure raised many issues among which legal personality issue is the most important. In fact, the whole structure was borrowed from the English law and hence raised doubt about its compliance with *Sharī'ah.* Accordingly, the study aims to re-examine the structure of corporations and the provision of debt finance under the principles of Islamic law and their effect on the economy as compared to the partnerships. The study combined different approaches such as library research, content analysis as well as case study to help answering the research questions. Findings were that neither the financial intermediation theory currently in use, nor the fractional reserve theory proved to be correct. The only correct theory that is supported by an empirical evidence is the money creation theory which states that banks can create money out of nothing. The study also found that Islamic banks are not different from conventional banks in terms of the economic substance. Moreover, after analyzing the concept of legal personality, the study found that this concept was not accepted by the classical scholars although the majority of the contemporary scholars insist on its validity. Finally, partnerships were found to be more efficient than the debt-based system in terms of allocating the investable resources and the marginal efficiency of capital. Some recommendations were given in the last chapter that help improving equity-based financing and partnerships. The suggestions included legislating *muḍārabah* and *musharakah*, restructuring and implementing Islamic private equity funds, codifying Islamic financial law and adopting some of the existent fintech strategies and innovate new ones in order to improve equity-based investment and hence improve the whole economy creatively while minimizing costs. The study also suggests carrying out future research especially on the concept of separate legal personality and calls the contemporary scholars to participate.

خلاصة البحث

قبل ظهور النظام البنكي كان التمويل بالدَّيْن يُعتبر استثناءً بين أوساط المسلمين. فكانوا يسلِّفون بعضهم عن طريق القرض الحسن بقصد الصَّدقة دون انتظار أي مكسب من تلك القروض. وقد كان التمويل المبني على المشاركة والمضاربة هو المصدر الأساسي الذي اعتمد عليه المسلمون في تجارتِهم في عهد رسول الله ﷺ، بل وقبل ذلك. ولم يكن هذا حصريًا على المسلمين فحسب، بل إنَّ سكان دول أوروبا في العصور الوسطى اعتمدوا في تجارتِهم على ما يسمَّى ب"الكوميندا" *commenda* وهي المضاربة و"السوسايتس" *societas* وهي المشاركة، وقد نقلهما الأوروبيُّون عن المسلمين كما أثبت المؤرِّخون. ولكن مع ظهور البنوك والشركات *corporations* تغيَّر النظام المالي بشكلٍ كلي وبدأ دور الشراكات بالتقلُّص، فأصبحت البنوك هي المصدر الأساسي للتمويل بالدَّيْن والشركات هي المقترض الأساسي لكونها تعتمد اعتمادًا أساسيًا على القروض في عملِها. بينما كانت الشراكات تؤدي الوظيفتين معًا في آنٍ واحد، فقد كانت تجمع بين رأس المال والعاملين تحت مظلةٍ واحدة. وقد ترتَّب على هذا التغيير الكبير في النظام المالي عدَّة قضايا: على سبيل المثال لا يوجد إجماع بين علماء الاقتصاد عن كيفيَّة عمل البنك وما إذا كان خلق النقود في صلاحيته. وقد تم وضع ثلاث نظريات عن كيفية عمل البنوك ولا يوجد إجماع على واحدةٍ منها حتى اليوم مع أنَّ كل واحدة مبنية على أسسٍ مختلفة وتؤدي إلى نتائجٍ اقتصاديَّة وسياسات مختلفة تماماً. أمَّا الشركات فقد أدَّت إلى ظهور العديد من القضايا بين علماء المسلمين أهمُّها مفهوم الشخصية الاعتبارية للشركة. في الواقع، لقد تمَّ نقل وتطبيق نظام الشركات كما هو من القانون الإنجليزي، مما أدَّى إلى التشكيك في مدى توافق تلك الشركات مع أحكام الشريعة الإسلامية. يهدف هذا البحث إلى إعادة دراسة وفحص هيكليَّة البنوك والشركات التجارية، ومدى توافقها مع أحكام الشريعة الإسلامية. بالإضافةِ إلى تحليل الأثر الاقتصادي النَّاتج عن تطبيقها ومقارنته مع النظام المبني على الشراكات. وقد اعتمدت الدراسة على ثلاث طرق أساسيَّة في الإجابة عن الأسئلة المتعلقة بالبحث وهي البحث المكتبي، وتحليل المحتوى، ودراسة حالة. ومن ضمن استنتاجات البحث أن النظريَّة البنكيَّة الصحيحة الوحيدة المثبتة بالأدلَّة العمليَّة هي نظريَّة استحداث النقود أو خلق الائتمان *credit creation theory*، والتي تنص على أنَّ البنوك تخلق الأموال مع كل عمليَّة إقراض. كما أثبتت الدراسة بأن البنوك الإسلاميَّة لا تختلف ضمنيًا عن غيرها من البنوك الربويَّة. وبالرجوع إلى النصوص الأصليَّة، أثبتت الدراسة بأن الفقهاء قديمًا لم يعترفوا بإثبات الشخصيَّة الاعتباريَّة لغير الآدميّ بالرغم من إصرار كثير من الفقهاء المعاصرين على إثبات الشخصية الاعتباريَّة للشركة. وأخيراً أثبت التمويل المبني على الاستثمار والشراكات بأنه أكثر كفاءة من التمويل المبني على الدَّيْن في كثيرٍ من الجوانب الاقتصاديَّة منها استغلال الموارد القابلة للاستثمار وغيرها. وأخيراً تمَّ وضع بعض الاقتراحات علَّها تسهم في تنمية الاقتصاد الإسلامي، منها سن قوانين تنص على تطبيق المشاركة والمضاربة من قبل حكومات الدول الإسلاميّة، بالإضافة إلى تقنين الشريعة الإسلامية. هذا وبالإضافة إلى إعادة هيكلة وتطبيق ما يُعرف بصناديق الاستثمار الإسلاميّة الخاصة. وأخيرًا استغلال التطوُّر السريع الذي تشهده التكنولوجيا الماليّة أو ما يعرف ب *Fintech* في كثيرٍ من المجالات مثل إدارة الاستثمارات وغيرها. كما اقترح البحث عمل دراسات مستقبليَّة من قبل المختصِّين والفقهاء خاصَّةً فيما يخص الشخصيَّة الاعتباريَّة للشركة.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science (Islamic Banking and Finance).

AAbdullah

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Supervisor

This dissertation was submitted to the IIUM Institute of Islamic Banking and Finance and is accepted as a fulfilment of the requirement for the degree of Master of Science (Islamic Banking and Finance)

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Syed Musa Alhabshi
Dean, IIUM Institute of Islamic Banking and Finance

DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Shams Osama Abdeltawab Abdelkader

Signature.. Date ....6/8/2019.............

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ACKNOWLEDGEMENTS

All the praise goes to Allah (swt), *alhamdulelah* for choosing me and using me as a tool to learn and spread part of the Islamic knowledge. *Alhamdulelah* for facilitating all the required facilities to reach and spread knowledge, and *alhamdulelah* for giving me the ability, intellect and strength to do this study.

I would like to express my deepest appreciation to my supportive supervisor Assoc. Prof. Dr. Adam Abdullah, who helped me all the way until finishing the researcher. I would like to thank him for his patience, passion and advices, without his support and persistence help this research would not have been possible. I would also like to thank everyone participated and helped in this study especially the examiners Assoc. Prof. Dr. Romzi Bin Rosman and Asst. Prof. Dr. Habeebullah Zakariyah who gave me very valuable comments, and thanks to the whole staff of IIiBF, especially Mr. Ahmed Zulhilmi, for their continuous support and cooperation.

I am also extremely thankful to Assoc. Prof. Dr. Ibrahim Nuhu Tahir to whom I owe a deep sense of gratitude for answering all my questions immediately and giving me very insightful comments. And I profusely thank Mr. AbdulManāb Wahāb, the former CEO of Bank Mu'āmalāt for sharing his valuable thoughts on email that helped me seeing the truth clearly. Finally, my deep profound appreciation goes to every lecturer taught me in IIUM and every scholar wrote about this topic with honesty and with the aim of spreading the truth and support the cause of Allah (swt).

Finally, and by no means least, all my privilege, appreciation, gratitude and love go to my dear father and mother Dr. Osama 'AbdulTawāb, Ms. Zainab Rabī', and to my sister Wafā' and brother 'AbdulTawāb and my beloved and dear nephew Osāma Zakī for all their love, patience and support, and all the hardships they faced in order to see me succeeding in my life. I will never be able to thank them enough. I am also sincerely grateful to my dear friend and second sister Hibah for all her encouragement and continued support and concern. May Allah (swt) protect them and guide them always to the right path.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

Previously, partnerships were the main provision of private equity finance used in commerce world widely, both in the Muslim and non-Muslim countries. Classical Muslim scholars (*fuqahā'*) have then given it significance and wrote clear principles to govern its operations, such that each school of *fiqh* (*madhhab*) has different forms of partnerships and sometimes slightly different provisions. Among all, the *Ḥanafī madhhab* has invented the most developed model for business organizations which can be relied on in the modern time, and all the features of *mushārakah* and *muḍārabah* were fully established by this *madhab* during the Eighth century (Çizakça, 1996, p.5). Some other schools of *fiqh* like the *Shāfi'ī* for example has a very restricted model, but its principles as well as the other two schools' principles will also be considered in this study.

Partnerships which entirely depend on equity were considered the best channel used by Muslim investors due to the transparency and the protection of each party's right and because it includes real economic activities rather than just growing money out of lending, and many scholars adopted studies that showed its importance and positive impact on the whole economic system.

Furthermore, partnerships were the prevalent method for commerce since the prophet time as he (pbuh) and his noble companions (may Allah be pleased with them) themselves used to engage in *muḍārabah*. He (pbuh) used *muḍārabah* with his wife to be *Khadījah* (may Allah be pleased with her) by investing her money and being her agent (Udovitch, 1970, p.186).

Not exclusive to the Muslim society, partnerships also reached Europe through what's called the *commenda* and *societas*. Hence many writers were interested to write about the origins of these forms and the majority agreed that they are an extension of the Islamic *muḍārabah* and *mushārakah* respectively (Çizakça, 1996, p.12).

But this equity-based system is no longer the prevalent since the whole financial system was altered with the inception of the banks. Banks actually became the main provision of debt financing; their main job is extending loans and collecting fixed return out of it. Scholars have not yet come to any consensus about how the banks and money are functioning under the banking system, and they have developed three theories where each theory leads to totally different economic and policy implications. Following this, a new form of business organization started to originate through some gradual legislations made by the English law. This form is called the corporation which was known as the joint stock company, where joint stock refers to the assets of the company. Corporations' origin goes back to the Sixteenth century and were probably initially found in Italy (Nyazee, 2016, p.92). In the beginning, establishment of such companies was a huge and difficult task since it required a special legislation by a Royal Decree, accordingly, people started to open companies without taking the permission which led to a number of financial disasters like the bubble companies until the state interfered by passing the Bubble Company Act in 1720. Following this, in 1825, another law was passed that permits the transfer of shares from one person to another, and in the following year, 1826, corporations were permitted to sue and be sued under their own name, which gave rise to legal personality concept. And finally, the concept of "limited liability" was acknowledged by the English law in 1844 under the so-called "Limited Liability Act of 1844". Furthermore, although there was a debate regarding the limited liability form of partnerships in Britain, later on it was accepted (Nyazee, 2016b, p.365).

Surprisingly, this whole system, which as mentioned was originated and established in England, is borrowed by almost all the Muslim countries today.

In order to cope with the new situation, contemporary Muslim scholars found a need to issue new legislations to help Muslim investors investing and participating in the economic growth, hence the corporation structure and indeed the legal personality concept were accepted and applied, and they have also accepted the structure of banks after being Islamized and called Islamic banks.

But some scholars did not agree on the new debt-based system, and this in turn led to differences in opinions and many researchers and writers started to explore new doors to study.

Concerning the banking system, there have been three different theories up until today, where each theory is built on different understanding on how money is created and how the banks are functioning. One of the theories, namely the credit creation theory, states that banks are creating money out of nothing and they are the main suppliers of money in the modern time, while the financial intermediation theory for instance states the opposite, i.e. the banks are mere intermediaries and can never create money, and accordingly do not have major effect on the macroeconomic level. These huge differences between the theories drew the attention of many writers and practitioners to find which theory is correct.

Moreover, some think that Islamic banks are not different than the conventional banks in terms of the economic substance e.g. Abdullah and Wahāb.

On the other hand, there have been many issues attached to the structure of the modern corporations, the most prevalent one is the legitimacy of the legal personality concept, and whether it was acknowledged or even known by the early Muslim scholars "*fuqahā*". Many Muslim and non-Muslim writers like Alqarradāghī, Sanūsī, Al-Zuḥaily, Udovitch, Joseph and others gave this concept great attention and reached similar conclusions except few of them. One of the exceptions is the well-known contemporary scholar Nyazee, who wrote on both the issues related to partnerships as well as corporations and questioned many of the other writers and contemporary scholars and also questioned the Islamic *Fiqh* Academy (OIC) for many of the opinions and legislations they have written. He further claims that modern Muslim scholars have not asked enough and very important questions before approving the structure which was borrowed from the non-Muslim English law, and he claims that some scholars in addition to the FASB have confused between the mercantile notion of the firm and legal personality concept.

Indeed, as the whole structure of corporations was actually copied from the English law which is based on torah and gospel, it has to be very critically analyzed before being accepted and considered *Sharī'ah* compliant. But unfortunately, few literatures were found analyzing the corporations' structure under the principles of Islamic law.

Even those researchers who talked about the legal personality issue, they all have used almost the same fragmented approach in concluding their opinions. In fact, not only legal personality, many other questions related to the current financial system need to be answered. Such as, is trading in shares nowadays deemed legal under the Islamic law? What is the effect of partnerships as opposed to corporations and banks on the economy? Why the implementation of partnerships has been almost ignored by Muslims? Etc.

But on the same time, the issue of legal personality is considered the most important and requires more attention since the new model of business organization is built on its basis, hence Muslim scholars and writers have responsibility to examine its validity.

1.2 PROBLEM STATEMENT

Currently, the provision of debt finance is prevalent all over the world. The Prophet (pbuh) said: "There will certainly come a time for mankind when everyone will take *ribā* and if he does not do so, its dust will reach him" (Sunan Abū Dawood, book 22, ḥadīth 3325).

This was never the case in the past, where debt was an exception and not the main rule. Muslims used to treat loans as an act of charity by using *al-qarḍ al-ḥassan* and were never expecting any return out of a loan. Not only this, while *mushārakah* and *muḍārabah* were the main partnership forms used by Muslims, *commenda* and *societas* were the partnership forms prevalent in the West and are largely equivalent to the Islamic *muḍārabah* and *mushārakah* respectively, because they were actually copied from them as has been proved by the historians.

The invention of the banking industry and the corporations in fact altered the whole financial and economic systems. As will be shown in this study, unlike partnerships, which is based on profit and loss sharing, loans are the main source of funding under the current system, and hence people shifted form equity-based to debt-based financing. In addition to this, the process of money creation has also been changed. Where some argue that central banks are the main controllers of the money supply in the economy by controlling the interest and reserve ratios, others claim that central banks do not have this authority and commercial banks actually create money out of thin air due to the double entry bookkeeping system, and consequently produces a factitious purchasing power. Three different theories of banking have been established so far by scholars, and while there should be only one correct theory, there have been no consensus about the correct one yet. Each one of these theories is built on totally different basis and understanding of how money and banks function, therefore each theory leads to different economic and policy implications. A. Bianco and Claudio Sardoni in their study about the effect of banking theories on the macroeconomics stated that failure to incorporate the existing studies of how banks work into the models used in macroeconomics will lead to underestimating the effects of changes in bank lending on the real economy (Bianco & Sardoni, 2014).

The current financial system is predicated on the understanding that banks are mere intermediaries and based on this many new rules and regulations were established to achieve financial stability such as the capital adequacy-based approach as reflected in Basel I and II, and many other regulations based on the same idea, but in fact, financial crises are keep increasing rather than decreasing. According to Abdullah, since 2017 there have been 425 incidences of debt and financial crises, which proves that the current system is working under incorrect basis (Abdullah, 2018b, p.29). Warner also stated the following: "The capital-adequacy based approach to bank regulation adopted by the BCBS, as seen in Basel I and II, has so far not been successful in preventing major banking crises" (Werner, 2014a, p.2). So, predicting the correct model should lead to financial and economic stability through designing appropriate regulations based on the assumptions made under the correct model.

Moreover, Corporations business mainly depends on loans given by banks and indeed heavily depends on debts (Poulsen, n.d.); hence it became the dominant form of business organization in the modern time. And although the structure of modern corporations was originated in the West, precisely through gradual legislations made by the English law, which is predicated on the torah and the gospel, no enough questions concerning the legitimacy of its structure under the Islamic law have been raised by the contemporary scholars before accepting it.

In fact, the rise of corporations gave rise to many issues that are still not settled by the contemporary scholars, most importantly, the concept of legal personality. Under this concept the corporation is considered a separate legal entity distinct from its owners, which means it can sue and be sued under its own name and have a perpetual life as will be shown later in this study. Most contemporary scholars and organizations like the OIC, FASB and others have legislated this concept, while on the other hand other scholars have criticized their opinion, and accordingly there is no consensus and the issue is not yet settled.

It is very important to reach a consensus among scholars regarding the legitimacy of this concept and the legitimacy of the structure of corporations as a whole because this is the structure that have dominated the whole world including Muslims. It is very important to answer these questions: does this structure comply with *Sharīʿah* and does not break any principle? What is the methodology followed by the scholars to reach the final *hukm* and what are their reasonings? Did they study the structure of this system precisely before giving the final decision? And what are implications of accepting this structure and replacing it with the partnerships? in other words, what are the implications of making debt the rule instead of being the exception as was the case in the Muslim world under the equity-based system?

Unfortunately, very few researches _if any_ were found analyzing the structure of the modern banking and corporations under the light of Islamic law. Instead the focus is given to Islamizing the banks and corporations while ignoring the basic structure and model under which they are built. A considerable number of researches have been found focusing on developing and inventing new products for Islamic banks, while no one is questioning the effect of this debt-based system on the economy. Does it satisfy *maqāṣid al-Sharī'ah* and spread justice in the society? This research is meant to examine the structure of the financial system (including banks and corporations) under the light of *Sharī'ah* and study the economic and policy implications of the current debt-based system as opposed to the equity-based system.

1.3 RESEARCH QUESTIONS

1. How does the structure of banking affect the provision of debt finance?
2. How is the structure of modern corporation different from Islamic partnerships and the mercantile notion of the firm?
3. Why is Islamic equity finance more efficient at allocating investable resources to growing economy?

1.4 RESEARCH OBJECTIVES

1. To investigate the mechanics and structure of modern banking and the provision of debt finance

2. To re-examine the structure of the modern corporation in terms of legal personality in contrast to the mercantile notion of the firm
3. To analyze the structure of Islamic partnerships, the provision of equity finance and its impact on the economy

1.5 SCOPE OF THE STUDY

The undertaken study basically deals with and focuses on critical *Sharī'ah* issues related to the structure of the modern corporation as well as the modern banking system. The issue of legal personality was thoroughly studied and analyzed by referring back to the original texts of the *fuqahā'* like Al-Sarakhsī, Al-Kāsāni and others and by gathering contemporary Muslim and non-Muslims scholars' opinions about the issue like Alqarrahdāghī, Nyazee, Udovitch, Sanūsī, Al-Zuḥaily and others. Other issues related to the structure of the modern corporations have also been discussed. The process of money creation under the current financial system and the three theories of banking have been studied and finally the correct theory was determined by analyzing an empirical test done by Werner (2014) and by referring to other studies done by McLeay (2014), Abdullah (2018) and Wahāb (2018). Moreover, the differences between the Islamic and banking systems were elaborated by analyzing a number of studies and by contacting the former CEO of bank Mu'amalāt; AbdulManāb Wahāb, through email. The email has been attached in the study in Appendix II.

Furthermore, different forms of partnerships as found in Islamic law (*fiqh*) and as found in the modern law whether in the Muslim or non-Muslim countries were listed and elaborated in the beginning, as well as basic principles of Islamic law, in order to have a clear picture before going through deep details. Reference was made to the original sources like Al-Mabsūt, the English common law, AAOIFI *Shari'ah* standards, and others when necessary.

Finally, through analyzing several economic studies about the marginal efficiency of capital (MEC) under the two financial systems like the studies adopted by Sadeq (1990), Keynes (1936) and Abdullah (2015), a comparison and finally a conclusion was drawn about the final economic effect under both systems (i.e. banks and corporations vs partnerships) in order to have a clear picture on the best system that should be implemented to help growing the economy without breaking any principle of Islamic law.

1.6 SIGNIFICANCE OF THE STUDY

This study is motivated to find which financial system will best suit and grow the modern economy and in the same time comply with the principles of *Sharī'ah*.

It is anticipated that this paper will contribute to the very limited number of literatures found in this area especially that it merges the most vital topics that will help to differentiate between the equity-based financial system and the current debt based-financial system starting from studying the basis over which each system was built and structured and ending with the economic impact of each using classical and contemporary scholars' texts. In other words, this study gives a clear and full picture about the current debt-based financial system as opposed to the equity-based financial system in many aspects, concerning the structure, compliance with *Sharī'ah*, effects on the economy and fulfillment of *maqāṣid al-Sharī'ah*.

Furthermore, it was written with the hope of drawing the attention of our respected contemporary Muslim scholars on the inconsistencies found in some opinions and legislations given by them and by other Islamic institutions about the structure of the modern corporation, modern banking and the concept of legal personality, and also with the aim of having codified *Sharī'ah* principles that will help Muslim investors invest confidently without any need to refer to the English courts in case of legal disputes. Moreover, after analyzing the importance of *muḍārabah* and *mushārakah* on the economy and on achieving *maqāṣid al-Sharī'ah*, the study highly recommends the scholars to interfere in order to recognize these two forms by the Muslim countries' laws, the study also enhances researchers and writers to pay more attention to the implementation and development of partnerships.

Furthermore, the underlying study will open a new door for researches as some issues still need more elaboration and not yet settled especially issues related to the structure of the modern corporation. It also suggests researchers to adopt new studies focusing on improving Islamic partnerships using different techniques including fintech.

1.7 ORGANIZATION OF THE STUDY

This study is divided into five chapters. The first and current gives background about the study, and also discusses the study's primary questions and objectives. Next chapter will basically merge considerable number of literatures related to the underlying topic that will help in answering questions raised in the current chapter. It will first start by explaining the modern banking system and elaborating the three banking theories, then a detailed explanation will be conducted regarding the structure of the modern corporation and the issues related to it, namely, the separate legal personality as opposed to the mercantile notion of the firm. After that, the chapter will elaborate on the different definitions and forms of partnerships under both Islamic and English laws. The most important and relevant *Sharī'ah* principles will be discussed in the following section. These principles will be used extensively in the legal analysis done in the findings concerning the corporations and banks structures. A brief discussion will be given in the following section about the marginal efficiency of capital (MEC) that will be elaborated further in the findings. Finally, there will be a conclusion summarizing all these sections by the end of the chapter. In chapter three, the methodology and the different approaches employed to adopt the study will be discussed.

Chapter four discusses the study findings extensively and in accordance with the order of the research objectives and is divided into six sections. The first section gives a brief introduction about the flow of the chapter. Section two then answers the first research question and is divided into six sub-sections all related to the banking system. The following section is divided into three sub-sections and deals with the corporations' structure. This section is considered the core of this study.

Fifth section deals with the partnerships and the MEC and adopts a comparison between the two financial systems. After that, an important discussion about the fulfillment of *maqāṣid al- Sharī'ah* under the two financial systems will be adopted in the fifth section and finally the sixth and last section of the chapter summarizes it. The fifth and last chapter summarizes the whole study and gives some recommendations for developing the economy and adopting future research, in addition to the limitations of the research.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The main and prime aim of this study is to ultimately find the financial system that best suits and benefits the society under the light of the Islamic law. The researcher will study the current debt-based and equity-based financial systems and analyze their effects on the economy in order to predict the best system that will help the whole economic system to grow and to maintain financial stability. The current financial system is mainly based on debt as banks are considered the main provision of debt finance and corporations are the demanders. Hence in order to predict the best system, we need first to examine the structure of the banking industry by concluding on the correct theory and the process of money creation, and finally to analyze how this structure is affecting the economy. So, in the current chapter an overview about the banking industry will be given and the three theories will be defined. The critical analysis will then be done in the fourth chapter.

Then the researcher will examine the structure of the modern corporation by discussing *Sharī'ah* issues related to its structure, e.g. legal personality concept. The researcher depends on the original texts of the classical and contemporary scholars for the legal analysis. In this chapter all the views will be shown while the comparison and critique will be done in the findings.

After that a brief overview about the partnerships will be conducted, including its definitions, forms, and rulings by referring to the original sources of Islamic law under