



MUDARABAH: A PARTICIPATORY MODE OF FINANCING UNDER ISLAMIC BANKING AND FINANCE

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Abstract

Mudarabah is considered as a perilous partnership contract, in which both the parties agree to the decided portion of the profit from this financed activity. On the practical side, Mudarabah is a form of an arrangement which consists of capital and labor. Capital is provided by Rab-ul-Maal while services are rendered by Mudarib. This Islamic instrument of equity financing, faces agency problem as well as other ethical hazards. This contract carries some risks related to agency, capital and operational risks, issues adjoining profit and loss sharing. The paper emphasizes the significance of extenuating these risks. What is the rationale behind this exercise that only investor bears the loss? Whether there exists any scale that can measure diligence and care of Mudarib in the exercise of his duties? The reason behind this is that the person who owns capital is not empowered to exercise check on the management and how Mudarib can be ranked trustworthy, what will be remedial mode in situations where Mudarib breaks the trust? Mudarib cannot make profit of the agreed percentage due to market fluctuations, these complexities are the focal point of this paper. The complications relating to agency problems in Mudarabah and their effects on economic relations of opposite parties are also the focus of this research. Major concepts and legitimacy of Mudarabah are also discussed to establish their compliance with Shari'ah and to make it reader friendly. The qualitative research methodology is employed in the accomplishment of this paper for literature review. The researcher reviewed different books, journals and papers of different writers well versed with the knowledge of Islamic finance. The primary objective behind this piece of writing is to highlight the ways and instruments that can resolve key issues associated with Mudarabah and how this participatory mode of financing can be made more valuable and practically acceptable to both investors (Rab-ul-Maal) and Mudarib.

Key words: Mudarabah, Rab-ul-Maal, Agency Problem, Moral Hazard, Adverse Selection

1. INTRODUCTION

The term Mudarabah is usually second-hand with **qirad** and **muqaradah** according to one belief (Sapuan, 2016). Mudarabah was first originated in Iraq but the terms qirad and Muqaradah were originated in Hijaz (Astrom, 2012). For the same kind of contract different words for their description are used, for instance, Maliki and Shafi schools of thought, used Qirad and Muqaradah for such kind of contract while Hanfi uses Mudarabah. "The term Mudarabah is derived from the term of setting on a journey (Sapuan, 2016). It is so referred as it entitles agent to earn profit as an outcome of his efforts on this journey of equity. This bond was recognized as Mudarabah by the people of Madina according to Al Sarakhsi Al-Mabsut (Ramli, 2016).

It is that form of undertaking or contract which is usually concluded with the investment account holders who provide funds, however, Islamic bank acts as a Mudarib (IIBI, n.d.). The Islamic financial institutions receive amounts from investment account and this principal is utilized according to the settled terms of the contract (IIBI, n.d.). If Mudarib (here it is bank) is sovereign in decision making, then it would use the capital for the generation of profit. The distribution of the profit raised would be based on a ratio which was decided with the mutual consent of the parties (IslamicMarkets, 2023).

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In cases, capital owner will bear the loss, this is the most imperative issue in this mode of financing that makes it less attractive to banks (when it acts as Rab-ul-Maal). On the contrary, when profit is generated, Mudarib is considered solely responsible for the generation of profit (Hussain, Shahmoradi, & Rurk, 2015). When banks are on the liability side the service provider also faces risk because there is no scale to measure that Mudarib is carrying out his work diligently or he is negligent in performing his duties (Greuning & Iqbal, 2008). He can be accused with misconduct as well as negligence and can be held liable. Therefore, in both situations' extra precautions, in handling the issues with same cannon should be taken.

2. LEGITIMACY OF MUDARABAH CONTRACT

The recognition offered to this contract is the result of ease, success and efficiency in the operation of economic system. This type of trading actions has a positive and flourishing effect on the state of laborers. The manager of this contract would preferably be the person authorized of enhancing consultations and to bring investment on those lines that would be beneficial for all the parties to this contract as attributed to **Ibn Rushd Abu Walid Muhammad Bin Ahmad** (1996) in (Mujaddid, Khasanah, & Fahrocin, 2021). As narrated in *Bidaytul al-Mujtahidwa Nihayat al-Mujtahid, Beirut: Dar al-Kutub al-Ilmiyyah* and cited in (Rahman, 2018) Mudarabah is allowed because:

"People have a need for this contract. For the owner of capital may not find his way to profitable trading activity, and the person who can find his way to such activity, may not have the capital, and profit cannot be attained except by means of both of these, that is capital and trading activity. By permitting this contract the goal of both parties is attained" (Ramli, 2016).

The people of Madina at that time regarded this form of transaction of business, a mean to happiness. They were contented with the portion of profit that was determined at the time of conclusion of contract. This was a tool of encouragement for them to work harder because every increase in the gross income raised their amount of share.

The legality of Mudarabah is sworn by the scholars of all schools of thought. To prove this, they cited verses from the Qur'an and traditions of Sunnah. The following verse confirms the legitimacy of this form of trade:

"And others who walk on this earth, in quest of the reward of the Almighty" (Al-Qur'an, 73:20).

A significant example is from the life of **the Holy Prophet (PBUH)**, **Hazrat Khadijah** gave capital for trade and our Holy prophet Muhammad (PBUH) did business activities from the provided funds (Uyuni, 2021).

As narrated in (IIBI, n.d.), in the Sunnah, Mudarabah has a connection which is explained by **Ibn 'Abbas** while saying,

"Our tribal leader, al Abbas ibn Abd al Muttalib, whenever he paid money out in Mudarabah, he also gave instructions about the limitation of the contract and explained to his partner that he must not cross over water with his money, or make camp out in a dry riverbed, or buy a fractious mount with it. If his partner did any of those things, he would be apprehended personally liable. When news of these conditions reached the Prophet of Allah, peace be upon him, he sanctioned them."

According to **Al-Sharaksi**, emergence of this contract was the need of time, because the person who was having money but he was not competent to utilize it for profitable gain and the person who was having knowledge and wisdom of business did not have resources resultantly, Mudarabah mode of financial activity emerged as a solution to this problem. In order to generate profit capital and trade are the essential elements, so permission to enter into Mudarabah transactions motives of both parties were achieved (Ramli, 2016).

3. POSITIVE AND ENCOURAGING ELEMENTS OF MUDARABAH

Mudarabah is that form of equity financing in which Mudarib is burdened with the trust and vigilance with respect to the funds proposed to him. Generally, if loss occurs Mudarib will not bear



that loss subject to his vigilance. In case where certain property is entrusted to Mudarib and he did not pay heed and found guilty of breach of trust, negligence and misconduct he shall be accountable for this (AAOIFI, 2004).

With the intention of avoiding any such risk Mudarib is asked to ensure guarantee of returning the funds in case of his being negligent and violating the terms of the contract. He is not permitted to sell the Mudarabah good at less than the market price or buy goods at a price higher than the market rate. He cannot bestow Mudarabah funds or waive receivables of the business without permission from the financier (AAOIFI, 2004).

Mudarabah can be concluded between two parties or more. In such cases where Mudarib himself feels difficulty in the accomplishment of the assigned tasks, he can hire another party to complete the task within the stipulated period.

For Example

Mudarabah is a contingent contract in which offer by one party is to be responded in the form of acceptance by the other. It is permissible that owner of the capital can conclude Mudarabah contract with multiple parties keeping single transaction. It can be better explained that the person with the capital gives money to two different parties acting as a Mudarib for each other and the capital is invested jointly, it reflects that there can be multiple number of Mudaribs depending on the need of Rab-ul-Maal.

Another valuable stage in Mudarabah is that this contract is based on terms and consent of Rab-ul-Maal, which is advantageous because absolute independence can make contract voidable or even void. Like all other contracts, the contract of Mudarabah is valid only with respect to lawful objects of trade in such cases where some unusual step is to be taken by the Mudarib, it requires permission of Rab-ul-Maal and if his permission is not sought by Mudarib the contract will become voidable. On the whole, Mudarib is required to carry out his duties with due care and in consonance with the principal lines decided in the contract. Sometimes, there are situations when Mudarabah contract becomes invalid and Mudarib works as an employee.

4. CHALLENGES AND IMPEDIMENTS IN WORKING OF MUDARABAH

- Mudarabah which is also called a 'sleeping partnership' or 'profit-sharing' is a contractual bond executed between parties. He (Rab-ul-Maal) acts as a sleeping partner in case of the unrestricted Mudarabah. Rab-ul-Maal does not interfere, rather he only enjoys the profit which is pre-determined (Shrivastav, 2020). Rab-ul-Maal also oversees Mudarib's activities. If Mudarib refuses monitoring, it enunciates that despite the fact, capital is provided by Rab-ul-Maal yet he is not allowed to safeguard his interests by keeping an eye on the working of Mudarib (Shrivastav, 2020).
- In case of restricted Mudarabah or Mudarabah al Muqayyad, Mudarib is not at liberty to take all steps relating to business at his own rather he is dependent on the will of Rabb-ul-Mal (Blossom, 2020). This dependence on Rab-ul-Maal is also not good in the sense as when thoughts and hands of Mudarib are not free it affects performance of Mudarib. To resolve this issue there should be a framework regulating acts of both the parties instead of depending on each other's consent (Blossom, 2020).
- The contract of Mudarabah is intended to enhance business activities and is concluded only for a shorter period of one year or less. Both legal and real person are competent for Mudarabah contract. Its scope should be extended but the treatment of larger projects should be separated from smaller projects to encourage persons with meager resources. (Look for some nice alternative). Financing social projects through Mudarabah by commercial banks is especially important on account of its immediate relevance.
- Another primary issue regarding the capital of Mudarabah is that, in which form it should be provided to Mudarib. Different schools present different views about the form of investment for this contract like, Hanafi fiqh have consent on the liquid form of capital to be used for the generation of profit that is preferably given in the form of letting tenders to different companies.



However, there are certain restrictions regarding capital like a commodity can't be used as a capital because of insecurity associated with it and disputes can arise.

- In the view of other schools' equipment, land etc. can also be included as capital, in the same way all, resources except cash can be used as an intermediate step. But before using this asset as finance for Mudarabah, the value of that asset is to be determined first. Incorrect evaluation of assets renders Mudarabah contract invalid (TKBB, 2022). An asset owing debt cannot be used as a capital of Mudarabah, so, the capital provided to Mudarib must be free from all liabilities (AAOIFI, 2004).
- There is a strict bar to the conversion of debt into Mudarabah capital to prohibit the mistreatment of usurious loan being masked as a Mudarabahh, however; in reality the financier has to protect himself to recover the debt and return of that loan is consider illegal, under the cover of his share in Mudarabah profits (Ayub, 2012).
- Another problem related to capital is that, it is to be provided lump sum, no installment is allowed because it is a harsh approach. It should be amended so that it can be feasible for both of the parties to enter into such contract and could enjoy profit making by Islamic mode of financing (SBP, 2024).
- The capital of Mudarabah is prohibited to be used for trading in the things prohibited in Islam e.g. wine or swine. Classical jurists were not in favour of Mudarabah involving trade. However, contemporary jurists permit the use of Mudarabah extensively. Mudarabah can also be used by banks as an option for interest-based financing.
- Along with these complications of the contract, there are certain risks attached to this contract. Mudarabah is also subject to the similar business risks that can affect the operation and profitability of Mudarabah. These risks are classified into *internal*, *external* and *market risks*. This means that when market forces play their part, a change in the value of investment also takes place. This fluctuation in prices and income is usually of temporary nature and can be put down in response to a particular event for instance, general market conditions etc. Furthermore, if a business fails to make profit, and it is due to a human error, such a risk is termed as *human risk*.
- In a situation where policies and procedures adopted to carry out equitable business activities are functioning, profitability is affected, such type of risk is known as *operational risk*. The operational hazard varies from industry to industry, and this risk is considered before making any investment. It is said that those industries which are less exposed to human are less likely to suffer from such risk.
- *Credit risk* is that form of risk in which opposite party's ability to pay the finance in time is uncertain. Another hurdle in the smooth functioning of Mudarabah is that, it involves complex documentation and departmental formalities, because the technicalities of the contract are given prime importance. Another prerequisite is obtaining certificate from Shariah supervisory board which makes it more difficult for the parties to accept this mode of Islamic financing. On the basis of above-mentioned risks critics criticize Islamic banking system because it is failed to avoid and control Islamic moral hazards (Warde, 2000).

5. MUDARABAH IN PAKISTAN

A distinctive model of Mudarabah is operative for the last thirty years. Those who are parties to a contract of Mudarabah are free to carry out the business of their choice and they can introduce the product they wish, subject to the fulfillment of principles provided by religious board. Mudarabah ranks good among other methods of Islamic Financial System. In Pakistan, the route of transforming the economy of the country was started in 1977. After the recommendations of Islamic Ideology Council, certain amendments were made in almost all the laws governing the Islamic finance system. In reality, it was an effort to provide a legal umbrella for Islamic financial system. After achieving this milestone all ambiguities related to the Mudarabah were removed and it stated to be operated as a separate legal entity under the umbrella of legal framework including the



Companies Ordinance, 1984, Mudarabah Companies and Mudarabah Rules, 1981, and Prudential Regulations for Mudarabah, 2004.

The guidelines and framework provided by the legislative machinery as mentioned above helped to comply with the terms and conditions to regulate Mudarabah. It also abolished the risk of any involuntary breach of Shariah doctrine by the Mudarabah. It is a significant effort to develop the image of Mudarabah as a conscientious component of Islamic Financial Industry and will help building the ties of business with Islamic Banks, Mutual Funds and Takaful Companies.

6. BENEFITS OF INVESTING IN MUDARABAH

Following are the advantages of Mudarabah:

i. Halal Business

Mudarabah is that type of business in the financial segment which is founded on Islamic traditions, because the parties are accountable to the religious board. The members of this board also undergo strict scrutiny and they are selected by the Federal Government. It is a good opportunity for those who wish to invest in Halal business.

ii. Multiple Business Opportunities

The multiplicity of the Mudarabah concept and its application in different ways, offers a different ocean of business opportunities to the sector that includes financial activities, trade, manufacturing, equipment-rental, contribution in property development, managing different projects, portfolio management, imports, exports of goods and doing distribution business. Such a wide range of business activities is not offered to any other entity in the Islamic financial system.

iii. Tax Benefit

The proceeds from the Mudarabah contract, except Mudarabah contract that involves trading activities, is completely exempted from income tax provided they allocate 90% of their profits to the certificate holders. For trading Mudarabahs, the maximum tax rate varies from time to time.

7. CRITICAL ANALYSIS OF MUDARABAH

Through the accent of Islamic jurists and Islamic scholars of the past it is found that Mudarabah is considered as most preferable mode of financing.

Ibn Taymiyyah said in his *Majmu'al-Fatawa Vol 20* (Ibn Taymiyyah, 2021)

"Those who deliberate on the vital ideology would easily conclude the Musaqat, Muzarah and Mudarabah are closer to justice than hire".

Molana Taqi Usmani in his book *"Introduction to Islamic Finance"* (Usmani, 2011) mentioned multiple times that Mudarabah and Musharaka are perfect forms of financing respectively on 12, 15, 17, 72, 107 and 160. His comments on Mudarabah should be considered seriously:

"It should never be overlooked, that originally, Mudarabah is not a mode of financing. It is only a gadget to escape from interest and not an ideal tool for carrying out the real economic objectives of Islam. Therefore, this device should be used as a transitory step taken in the process of Islamization of economy, and its use should be restricted only to those cases where Mudarabah and Musharaka are not applicable".

Practically, this transaction has a problem of finding the definite total profit to be shared because micro entrepreneurs generally do not have appropriate accounts or fiscal statement. Mudarib does not provide any guarantee for the return of capital and financier is not sure about the profit as well.

Rather the contract is based on promise, good conduct and honesty of Mudarib. This is the foundation of success of Mudarabah contract, but it is useless because Islamic Financial Institutions receive lesser returns. On the contrary there is positive aspect that it is subject to unlimited and exclusive exposure to financial risk. A preventive mechanism is essential to deal with the problem of adverse selection, this is possible with the introduction of effective tools in place for equity financing, but before the application of this strategy the size of arrears and equity market of developing countries must be considered.



For instance, Pakistan uses equity financing where it is possible that through shares it can deny the claims of bankers, especially Islamic banks who are busy in hiding themselves under the mask of trust deficit and issues relating to documentation. When so many issues are involved, this makes Mudarabah contract less attractive and they ask why they should go for investment when there is no guarantee and multiple risks are adjacent to it.

In order to overcome these complexities two methods can be used. *Firstly*, Mudarib can be asked in addition to contributing skills bring some capital. The contract will still remain different from Musharakah as only the Mudarib is the working partner. *Secondly*, this can be resolved by making Mudarib responsible to loss to a certain limit. These tools do not violate the established principle because the suggestion is not to burden any of the parties rather making both the parties to share the burden of each other, Mudarib guarantee profit to the Rabb-ul-Maal.

Rabb-ul-Maal can be held liable to bear loss, but Mudarib by way of input with some capital will also attribute to loss sharing. These two covenants will help in decreasing and curtailing the problem of adverse selection, moral hazards and principal-agent conflict.

Illustration

Muzara'ah is also a form of Mudarabah contract in which Islamic bank provides land or cash for agricultural product and harvesting is done in consonance with the terms settled in the contract and in return profit is shared according to pre-determined ratio. This whole procedure needs expertise and capital with the intention of managing risks successfully because banks usually engage themselves directly while providing land or any other thing (Mirakhor & Iqbal, 1987).

The above suggested methods of resolving and mitigating risks must be acceptable, so that it can become a mean to achieve the goal of entering into that era where all the benefits annexed to the contract are fulfilled. Ironically, Islamic values like justice, equality, truth, trust, kindness, honesty and responsibility are often discussed in literature and seminars on Islamic Economics, indeed, the deficiency of these standards in practice is the major reason why participatory mode of financing does not provide the desired results.

CONCLUSION WITH RECOMMENDATIONS TO MAKE MUDARABAH CONTRACT MORE SUCCESSFUL

After discussing all the aspects about the legality, legitimacy and utility of Mudarabah through this detailed research, it can be concluded that Mudarabah is an effective and religiously safe mode for investment which can be further improved by taking following reformative measures:

1. The complexities of risks involved in the working of Mudarabah are faced by Islamic banks. Mudarabah financing, requires a comprehensive framework that can easily do risk reporting, control and its management extensively. By developing risk management framework, as the calculation of risk weight of assets of Islamic banks differs from the assets of conventional banks and credit risks all can be managed by this mode.
2. The effective method to measure risk is by maintaining good quality data and comparing it with the previous performance of the other part to clarify uncertainty and possibility of default by the party and the same can be improved by regularly keeping, maintaining and updating records through digital means with easy accessibility.
3. When a client gets capital from an Islamic bank, Islamic bank being Rab-ul-Maal trusts its client and his integrity and management skills, while placing expected return and capital both at risk which can be further improved by requiring and recording the complete details of the clients.
4. In contemporary working of Islamic banks they are successful in mitigating the degree of risk involved, however, Shariah regulations are still applicable. Mudarabah is used preferably by public limited Companies, transparency can be ensured through auditing of accounts, maintaining quarterly reported performance.
5. Another tool that can reduce the engagement of risks in the working of Mudarabah contract is that securities and guarantees can be introduced in the contract, but these should not be against profit or payment of capital. Instead, their motive should only be avoiding loss due to negligence or



mismanagement and delays in repayment of capital and to ensure profit even after end of Mudarabah.

6. Banks can provide money for those Mudarabah where it is showcased that, as to where the actual money will be utilized? For example, if a car dealer buys autos from manufacturer and then sells on installments it is good example of Mudarabah mode of financing.

7. Agency related issues can be overcome by the given method, that Mudarib should give compensation to the Rabb-ul-Maal in case of negligence on the part of Mudarib. The compensation given by Mudarib can be in the form of be questing part of his equity. Introduction of incentives for exercising honesty, and extraordinary performance should be given and bonus and reserve scheme can be built.

Mudarabah has potential to be modified as Islamic microfinance scheme. It is a mode of resolving the problems through reciprocity of people by those who lack capital and those who lack skills whereby both of them can exchange their specialties to attain their desired goals. The above stated suggestions can make Mudarabah mode of financing more satisfactory and widely functional in financial intermediation. This would also prove a way forward for fulfilling egalitarian objectives of an Islamic economic order.

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