The Islamic principles of Mudaraba

A shariah compliant financial scheme

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What is shariah?

- “O you who believe! Stand out firmly for Allah, as witness to fair dealing, and let not the hatred of others to you make you swerve towards inequality and depart from justice.”
  Qur’an 5:8
- In the business context, Shariah is a means of conducting business through a distinct set of rules designed to facilitate fairness.
- High correlation between Shariah compliant investing and socially responsible investing.
Where are Shariah rules codified?

- Interpretations of the Qur’an from various Islamic schools of thought
- Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) [http://www.aaoifi.com/](http://www.aaoifi.com/) (200 members, 45 countries, based in Bahrain)
- The fact remains: Shariah mandates are not always consistently applied from Scholar to Scholar. Information is asymmetric, and Shariah Advisers and lawyers skilled in the area become useful to work through the counter-intuitive results
Shariah terminology

- **Halal** – that which is permitted or compliant
- **Haram** – that which is not permitted
- **Riba** – charging of interest or unjustified increase
- **Gharar** – the taking of unreasonable risk; uncertainty
- **Maisir** – reliance on chance or speculation, rather than effort
What is mudaraba?

- Mudaraba is a contract that arranges cooperation in business investment between capital on one hand and entrepreneurship on the other, whereby the contracting parties jointly and commonly own the realised profit as per the agreement.
- The party providing the capital (investor) is known *rab al-Maal* and the manager is known as mudarib or *Amil* (lit. worker).
- Comparable to joint venture enterprises (when mixed with *musharaka*).
Mudaraba

- Risk sharing; profit and loss sharing
- Limited partnership: one partner provides capital; other partner provides expertise/effort and makes business decisions
- Restricted (muqayyadah) or unrestricted (mutlaqa)
- Examples:
  - funded participation arrangement
  - establishment of investment fund
Schematic:
Mudaraba capital

- In principle, the capital of Mudaraba should be provided in the form of cash.

- However, it may be presented in the form of tangible assets which will be valued as mutual consent. The value (in cash) of the assets will be the Mudaraba capital.

- The Capital of Mudaraba should be clearly known to the contracting parties and defined in terms of quality and quantity in a clear manner.

- Debt (receivable) can not be the capital of Mudaraba
Profit and loss distribution

- The contracting parties must stipulate in the contract the profit shares (in defined terms) for each one.
- The profit sharing ratio should be a) specific b) of the profit expected to be earned by the venture.
- Unknown ratio or ratio attributed to future settlement or ratio linked with the capital (in terms of x% of the capital) is not allowed and the transaction becomes void.
- A lump sum settlement as profit is not allowed.
- Losses in Mudaraba shall only be born by Rabb-ul-Mal and not the Mudarib.
- Mudarib will suffer loss in shape of not receiving anything as profit.
- The Mudarib shall only be responsible for losses if they were due to his negligence and willful misconduct (zameen).
Mudaraba in banking system

- Mudaraba as a mode of finance used by Islamic Banks for the following purpose:
- Mudaraba is considered to be the essential mode accredited by the Islamic Banks in their relationship with depositors who provide moneys to the Bank as Rabb-ul-Mal to be invested by the Bank as Mudarib on the basis of profitsharing according to specific ratios agreed upon.
- Islamic banks may use the same mode with the customer.
- Project Financing.
Figures

2010

Islamic Banking Asset Growth (US$bn)

- Global Islamic Banking Assets 2010: 826
- GCC: 127
- MENA (ex GCC): 25
- Malaysia: 38
- Rest of the World: 114
- Global Islamic Banking Assets 2012e: 1,130

Source: World Islamic Banking competitiveness report/Ernst & Young 2011/12
Assets of shariah banking

Shari’a compliant assets represent a significant portion of the total banking system assets of the region.
Why so popular?

- Despite: risk of no profit!
- Responsible investment/high capital returns
- Stable profit rates!
- Investment pool with profit
- Mudaraba banks → saving account
- Higher financial margin generation due to stronger retail focus
- Service rather than pricing trend
- Testing of future sukûk market (insurance schemes, Islamic ”bonds”)