Practice of Mudaraba and Musharaka in Islamic Banking

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[Abstract: *Though both growth and popularity of Islamic banking in Bangladesh is remarkable, two very important modes of Islamic investment i.e,. Mudaraba and Musharaka are yet to be practised. To give the Islamic banks a complete shape, there is no other alternative but to implement, practise and popularize the Mudaraba and Musharaka modes. At the beginning, IBBL practised Mudaraba and Musharaka modes but could not continue due to some problems. These problems are identified in this paper. The paper also develops an operating model of the Mudaraba mode of investment and examines the prospects of practising the Musharaka mode of investment in Bangladesh.***]**

I. Background

The early theoretical models of Islamic Banking were based on the concept of profit and loss sharing (PLS) through Mudaraba and Musharaka modes of finance. In practice, while on the liabilities side of Islamic banks interest has been replaced by PLS, on the asset side the alternative modes of financing being used by these banks are dominated by fixed-return modes such as Murabahah and Leasing. Islamic financial institutions assume the role of traders and use the modes of trade but remain financiers. This metamorphosis is achieved by 'legal' documentation and some self-persuasion. It does not, however, convince many; and the root of the problems faced by Islamic banking and finance today lies in this split personality. This is the most serious problem facing Islamic banking, an interest-free alternative. What is worse, if the alternative in practice is built around predetermined rates of return to investible funds, it would be exposed to the same criticism which was directed at interest as a fixed charge on capital. It so happens that the returns to finance provided in the modes of finance based on *murabahah*, *bai' salam*, *leasing,* and lending with a service charge, are all pre-determined as in the case of interest. Some of these modes of finance are said to contain some element of risk, but all these risks are insurable and are actually insured against. The uncertainty or risk to which the business being so financed is exposed is fully passed over to the other party. A financial system built solely around these modes of financing can hardly claim superiority over an interest-based system on grounds of equity, efficiency, stability, and growth, This problem is the main problem of contemporary Islamic banking, so much so that it can be characterized as a crisis of identity of the Islamic financial movement.

Though both growth and popularity of Islamic banking in Bangladesh is remarkable, two very important modes of Islamic investment i.e., Mudaraba and Musharaka are yet to be practised. To give the Islamic banks a complete shape, there is no other alternative but to implement, practise and popularize the Mudaraba and Musharaka modes.

1.1 Objectives

The general objective of the study is to find ways of effecting Mudaraba and Musharaka modes of investment in Islamic banking, where neither the capital nor return is guaranteed. The specific objectives are as follows:

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i. To identify the problems of implementation and practice of Mudaraba and Musharaka;
ii. To develop an operating model of Mudaraba mode of investment; and
iii. To analyze the prospects of practising Mudaraba and Musharaka modes of investment.

1.2 Methodology

The study is based on primary data collected through a questionnaire survey among the Policy Makers, Executives and Customers of Islamic Banks. They are 23 in number and working in Dhaka City. Six cases of Mudaraba and Musharaka investment of Islami Bank Bangladesh Limited have been studied at its Local Office, Foreign Exchange Branch and Gulshan Branch. The study has followed the method of purposive random sampling. From file study and questionnaire survey, it has been tried to find out and understand the problems and prospects of implementation and practice of Mudaraba and Musharaka modes of investment in Islamic banking.

An operating model of Mudaraba is proposed in the study. Like Mudaraba, Musharaka is a mode of PLS system. It is believed, therefore, successful implementation of the proposed operating model of Mudaraba in Bangladesh will pave the way for implementing Musharaka

The study has six sections. Section II discusses the problems of implementation of the PLS system as were found from the file study and questionnaire survey, while Section III discusses the operating model of Mudaraba mode of investment. Section IV and V show the prospects of Mudaraba financing scheme and implementation of Musharaka, respectively, and finally, some concluding observations are made in Section VI.

II. Problems of implementation of the P.L.S. System

Several writers have attempted to show, with varying degrees of success, that Islamic banking based on the concept of profit and loss sharing (PLS) is theoretically superior to traditional banking from different angles (for example, Khan and Mirakhor,1987). However, from a practical point of view, things do not seem that rosy. In the following paragraphs, the major difficulties found from the 'file study' and 'questionnaire survey', are discussed.

2.1 Financing

There are three main areas where the Islamic banks find it difficult to finance under the PLS system: (1) Participating in long-term and low-yield projects, (2) Financing the small businesses, and (3) Granting non-participating loans to running businesses.

2.1.1 Long-term projects

The banks are unable or unwilling to participate in long-term projects. It is also observed from the term structure of investment of Islamic banks that most of their investments are of short term and medium term.

The main reason, of course, is the need to participate in the enterprise on a PLS basis, which involves time consuming complicated assessment procedures and negotiations, requiring expertise and experience. The banks do not seem to have developed the latter and they seem to be averse to the former. There are no commonly accepted criteria for project evaluation based on PLS partnerships. Each single case had to be treated separately with utmost care and each had to be assessed and negotiated on its own merits. Other obvious reasons are:

(a) Such investments tie up capital for very long periods, unlike in traditional banking where the capital is recovered in regular instalments almost right from the beginning, and the uncertainty and risk are that much higher; and

(b) The longer the maturity of the project, the longer it takes to realise the returns; therefore the banks cannot pay a return to their depositors as quickly as the traditional banks can. Thus it is no wonder that the banks are averse to such investments.

2.1.2 Small businesses

Small-scale business plays a major role in productive sectors. They are also a major group among the bank's clientele. Yet it seems difficult to provide them with the necessary finance under the PLS scheme, even though there is excess liquidity in the banks. The observations of Raquib and Ahmed[1] is revealing:

"The service sector is made up of many small producers for whom the banking sector had not been able to provide sufficient financing. Many of these small producers, who traditionally were able to obtain interest-based credit facilities on the basis of collateral, are now finding it difficult to raise funds for their operations."

2.1.3 Running businesses

Running businesses frequently need short-term capital as well as working capital, and ready cash for miscellaneous on-the-spot purchases and sundry expenses. This is the daily reality in the business world. The PLS system is not geared to cater to this need. Even if there is complete trust and exchange of information between the bank and the business it is nearly impossible or prohibitively costly to estimate the contribution of such short-term financing on the return of a given business. Added to this are the delays involved in authorising emergency loans.

2.2 Legislation

There is still need for further auxiliary legislation in order to fully realise the goals of Islamic banking.[2]

No law has been introduced to define modes of PLS financing, that is Musharakah and Mudaraba. It is observed that whenever there is a conflict between the Islamic banking framework and the existing law, the latter prevailed. In essence, therefore, the relationship between the bank and the client, that of creditor and debtor, is left unchanged as specified by the existing law. The existing banking law was developed to protect mainly the credit transactions; its application to other modes of financing also results in the treatment of those modes as credit transactions.

2.3 Involvement in specialised non-bank activities

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[1] *Raquib and Ahmed, (2003) P.1.*
[2] *See Ahmed (2002).*

It is due to historical reasons that banks have evolved purely as a financial institution. They are suited to attract money, keep it in safe custody, lend it under safety, invest it profitably, and enjoy the capacity to create the means of payment. A bank has to maintain a balance between income, liquidity and flexibility. While allocating its funds it has to be meticulously sensitive about the factors like capital position and rate of profitability of various types of loans, stability of deposit, economic conditions, influence of monetary and fiscal policy, ability and experience of bank's personnel, and credit need of the area. So far, these banks thrive on a fixed rate of return, a portion of which is passed on by them to the depositor. Thus the entire effort of a bank is directed towards money management and it is not geared to act as an entrepreneur, trader, industrialist, contractor or caterer.

The question arises: with all these limitations can a bank claim any competence in trading or entrepreneurship, which is necessary for Musharakah or Mudarba contract, or can it act as an owner of a large variety of heavy machinery, transport vehicles or real estate to take the position of a lessor or, can it act as a stockist to buy and resell the entire stock of imports and exports that are needed by genuine traders?

Conventional banks do perform a certain amount of project evaluation when granting large medium and long-tern loans. But doing such detailed evaluation as would be required to embark on a PLS scheme, such as determining the rates of return and their time schedule, is beyond the scope of traditional banks. So is the detailed accounting and monitoring necessary to determine the actual performance.

Under Islamic banking these exercises are not limited to relatively few large loans but need to be carried out for nearly all the advances made by the bank. Yet, widely acceptable and reliable techniques are yet to be devised. This is confirmed by the fact that no consensus has yet been reached on the principles. Both the unprecedented nature of the task and the huge amount of work that needs to be done seem a daunting prospect. Many hundreds of trained and experienced personnel will be needed to carry them out.

2.4 Re-training of staff

The bank staff will have to acquire many new skills and learn new procedures to operate the PLS system. This is a time consuming process, which is aggravated by two other factors. One, the sheer number of persons that need to be re-trained and, two, the additional staff that need to be recruited and trained to carry out the increased work-load.

2.5 Other disincentives

Among the other disincentives, from the borrower's point of view, are the need to disclose his account to the bank if he is to borrow on the PLS basis, and the fear that eventually the tax authorities will know the extent of his business and the profits.

2.5.1 Accounts

When a business is financed under the PLS system it is necessary that the actual profit/loss made using that money be calculated. Though no satisfactory methods have yet been devised, the first requirement for any such activity is to have the necessary accounts. On the borrower’s side there are two difficulties:

<u>one,</u> many small-time businessmen do not keep any accounts, leave alone proper accounts;

two, large bookkeeping costs will cut into his profits. Furthermore, private businesses do not like to disclose their real accounts to anybody. On the banks' side the effort and expense involved in checking the books of many small accounts is prohibitive and will cut into their own share of the profits. Thus both would prefer to avoid having to calculate the actually realised profit/loss. To quote Iqbal and Mirakhor:[3]

…. "The commercial banks do face an element of moral hazard owing to the non-existence of systematic book-keeping in this sector. Additionally the reluctance of small producers to submit their operations to bank audits and the perceived enormous cost of auditing and monitoring relative to the small size of the potential credit makes banks unwilling to extend credit on the basis of new modes of financing to these small producers."

III. Operating Model of Mudaraba

3.1 Profit and loss sharing

The concept of profit-and-loss-sharing is based on the old Makkan practice of Mudaraba[4], which had been adopted by Islam. In the main form of Mudaraba there are two partners: the entrepreneur and the financier. The entrepreneur has the knowledge and necessary skills to undertake an enterprise and the financier has the funds. The entrepreneur has full control of the enterprise; the financier provides only the funds. The net profit of the enterprise is shared by the two parties equally or in a prearranged fashion. When there is a loss, however, the total loss is borne only by the financier.

In Mudaraba practice, banks shall use depositors' funds to finance projects of entrepreneurs. There will be three parties: (1) Entrepreneurs; (2) Depositors; and (3) Banks.

They will share the profits (or losses) in a pre-arranged ratio.[5] Therefore, the depositors will become the 'investors' and the banks will divide this threesome into twosome: (1) Investors (Depositors) – Banks, and (2) Banks - Entrepreneurs. In the first case the bank is the entrepreneur and in the second case the bank is the financier. So the position of the bank is an investment intermediary.

3.2 Investment accounts

There shall be an arrangement to open 'investment accounts' in banks. These are time deposit accounts accepted by the bank on the explicit understanding that the funds will be invested in projects on a "profit-and-loss-sharing" basis. These accounts bear neither guarantee of capital, nor of profit. It is a sharing of all risks.

3.3 Credit creation and bank money

Conventional commercial banks can create credit. This is their special privilege. It means that they can lend more money than they actually have in their possession. How much more they can lend depends on their assumption, based on their experience, about how much money, in cash, will be demanded by their depositors, on the average, at any given time. If they assume that they can meet all their cash demands by, say, 10 percent of the cash in their possession, then it is pointless, from their point of view, holding the rest of the 90 percent of

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[3] *Iqbal and Mirakhor (1987). P.25.*
[4] *See Saleh(1986) for a very good explanation of Mudaraba, pp.101-114.*
[5] *See, for example, Ahmad (1980), Iqbal and Mirakhor (1987), Siddiqi (1988), Rad (1991), IPS (1994), etc.*

the cash in their hands. They would rather lend it to their customers and earn interest. This 10 percent is called cash reserve ratio. The smaller this ratio the more they can lend and make an earning in the form of interest.

Suppose a customer deposit $1000 in cash into his account. Assuming that the cash reserve ratio is 10 percent, the bank can advance up to $9000 in loans on the strength of this cash deposit. This is credit creation.[6] The $9000, which does not exist in reality but only in the books of the bank, is called bank money. Yet, for all intentions and purposes it is money as good as any.[7]

Thus, this credit creating mechanism also allows Islami banks to sanction investment and thereby finance projects several times more worth than any individual or any other entity can finance with the same amount of money. Consequently, it reaps a huge amount of profit from a small amount of real cash, which itself is not its own! This is a special privilege of a commercial bank irrespective of traditional or Islamic.

3.4 Financing with bank money

We propose to use this bank money to finance projects on a full Mudaraba basis, instead of investing it on pre-fixed profit. In order to explain the concept, let us take an example.

Continuing the same example from the previous section, suppose a customer opens an investment account depositing $ 1000 in cash. Assuming that the cash reserve ratio is 10 percent, the bank can invest up to $9000 to finance a project. If the bank becomes a partner in an enterprise it will go into partnership with this amount as its capital investment. When a profit is declared by the joint enterprise it will be computed on the basis of $9000 as capital investment. But the real cash involved was only $1000; the $ 9000 was created by the bank. Suppose the enterprise's profit was $10 per $ 1000, which is one percent, then the total profit would be $90. However the actual money involved was only $ 1000 and thus the bank gets $90 per $1000. That is, the bank in reality earns a nine- percent profit. Thus though the declared profit was only one percent—a very low yield – the real profit was nine percent which is undoubtedly a very good profit, This is because the project was financed by bank money.

To drive the point home, let us assume that a private individual invested $9000 of his own and the bank invested $9000. Capitals being equal, they will have equal share in the profit (not considering the labour/management input on either side). In our example, $90 for the bank and $90 for the individual. The individual's profit is $90 for $9000 and hence a rate of return of one percent. But the bank's rate of return is really nine percent, because the $9000 used by the bank was money created on the strength of $ 1000 in the investment account.

It is this mechanism that we propose to use in financing commercial and social projects in a way that equitably rewards the participants in the project: the investor, the bank and the entrepreneur. This would enable the commercial banks to contribute to national development in a uniquely meaningful manner and with responsibility.

3.5 The general mechanism

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[6] *For an explanation of the mechanism of credit creation by commercial banks, see, for example, Robertson (1937), Korteweg and keesing (1959), King (1987), Siddiqi (1988) etc.*

[7] *Withers (1923). See Appendix C.*

The previous analyses of the basic concepts of Mudaraba, investment accounts and credit creation have helped us to develop the concept of *financing with bank money*. Now, we will develop *a mechanism* of investing funds from the investment accounts, managing their investment, and sharing the profits and losses therefrom.

3.5.1 The partners and their shares

There are three partners: the depositor, the bank and the entrepreneur. The depositor is a pure financier, he invests his money and plays no further part in the project. The entrepreneur is a pure entrepreneur, he is fully in-charge of the project and invests no money in his capacity as an entrepreneur. The bank, however, is in a peculiar position of investment intermediary (*not financial intermediary)*: it is both an investor—though investing depositors' money and "multiplying" it – and an entrepreneur to the extent of identifying viable project and ensuring its proper accounting and management. The bank invests neither its own money nor its own ideas, yet it provides a very useful intermediary and trustee and takes responsibility. The bank will be rewarded for this useful role it plays but be punished if it fails.
With the above in mind, we propose an equal share to all three partners when there is a profit. When a loss occurs, the entrepreneur will bear no part of it, but the bank and the investor will share the loss equally between themselves.[8]

To clarify, continuing our cited example, where the bank invested $9000 and the profit was $90 (i.e. a one percent profit), the entrepreneur will receive $30 (i.e., one-third of the profit), the bank $30 and the investor $30. The investor's actual deposit was $1000. Hence he receives a 3% return on his investment.

Suppose in the above scenario, the project suffered a 1% percent loss, i.e. a loss of $90. The total loss will be borne by the financiers: the bank and the depositor. Sharing the loss equally between the bank and the depositor, the bank will lose $45 and the depositor $45. This is a 4.5 percent loss to the depositor. The bank did not invest any money of its own, yet in the event of a loss it will have to bear its share. The real financier is the depositor, but the bank is the trustee and the "money-multiplier". It is the responsibility it takes to identify viable projects and to ensure their proper accounting and management that entitles it to a share in the profit. On the other hand, it is the possibility of a loss that should make it vigilant in its responsibility as a financier[9]. When there is no loss or profit, none of the partners suffer any loss or receive any profit.

In Table 1, given below, we present these and two other scenarios so that the profit/loss distribution scheme could be fully understood.

Table 1 . Profit/loss distribution among the partners
(Investment: $1000 cash, providing $9000 in bank money)

Scenario	**Project**		**Depositor**		**Bank**	**Entrepreneur**
	Amount	%	Amount	%	Amount	Amount
1.	90	1	30	3	30	30
2.	0	0	0	0	0	0
3.	-90	–1	-45	–4.5	-45	0
4.	900	10	300	30	300	300
5.	1350	15	450	45	450	450

[8] *This is our suggestion, and the figures make the arithmetic simple, which makes it easy to explain the principles involved. In practice, however, the banks are naturally free to set their own ratio or negotiate with their partners.*
[9] *cf. 2nd para, point 1 of this section for more clear understanding.*

Share in:				
profit	1	1/3	1/3	1/3
loss	1	1/ 2	1/ 2	0

The first three scenarios of the table represent what has been explained above. The last two scenarios show how greatly the profits are multiplied when the profit is higher. For example, when the profit is 10 percent, the depositor gets a 30 percent return; and nearly half of his investment when the project's profit rises by just another 5 percent. The bank and the entrepreneur get the same profits but theirs cannot be given in terms of return on investment since they began with no investment of their own. Their profit is for successfully "handling" a project of that size.

We see clearly, that so long as there is no loss everybody stands to gain, however small the profit may be. And the gain increases many folds as the project makes higher profits. When there is a loss, however, both the depositor and the bank lose heavily while the entrepreneur is unaffected.

3.5.2 A pool of funds and a series of projects

We had one project which had a definite beginning and end, such as a trade caravan in the old days. The financing could have been by one person or more but that made no difference to the argument. In the present context, however, instead of the direct financier-entrepreneur contract of old, we now have an intermediary –the bank. Consequently, we have two contracts: one where the bank and the entrepreneur are the parties and the other where the bank and the investor are the parties. In addition, the banks had to deal with several entrepreneurs (and projects) and several investors simultaneously; and for long periods of time or indefinitely. Therefore, though we can adopt the concepts and principles of Mudaraba partnerships of old, new operational procedures have to be developed taking into account the current situation. We will develop an outline of such procedures in the following paragraphs.

Firstly, these projects begin at different times and, some may end after some time and others may continue indefinitely.

Secondly, it is obvious that we cannot establish a direct link between any one depositor and any one project; neither a one-to-many nor a many-to-one direct relationship.

The situation is that we have a number of projects running simultaneously and a pool of money from several depositors which finance the projects. To accommodate these two situations we have to make some change to the old practices of Mudaraba.

As far as the first contract– that of the bank and the entrepreneur – is concerned, there is a direct connection between the parties; and the concerned project and its duration (or the dates of commencement and termination) are well defined. This is necessary in order to determine the profit/loss of the project and to share it between the parties. If the duration of the project is less than one year, the Mudaraba contract is well defined and there is no problem. If the project runs beyond one year, profit/loss may have to be computed and shared annually.

In the second contract - that of the depositor and the bank – there is no problem as to the direct link between the parties. The duration of this contract too is well defined – it lasts as long as the money is kept with the bank. But this contract does not relate to any given project, and thus to no particular profit or loss. So a practical solution has to be found to make the connection in this *three-way* partnership in order to compute and share the profit/loss.

Assuming that profit and loss accounting is done annually, it looks a more practical solution to consider the total net profit/loss of the bank from all projects together for each accounting year and share the profit/loss between the bank and the depositors annually. Consequently, from the depositor's point of view, all of the bank's Mudaraba operations could be considered as one single project of one-year duration.

One of the advantages in treating all the projects together is that a loss in one project may be covered by gains in the other projects. This is very important.

3.5.3 Mudaraba Certificate and Mudaraba Project Certificate

Now, there is the related problem of deciding when an investment became entitled to a share in the profit/loss from the first day of deposit or later? There are two cases.

Firstly, the depositor's share begins with the first day of deposit and ends the day he withdraws it. This is quite acceptable when the project is fully running. If someone invested on 1 January and withdrew on 31 December, then he will receive his full share of profit/loss for the year according to the size of his investment. In case he kept his money for four months, say, from 1 August to 30 November he will get one-third of the full share.

Secondly, when the system is still in its formative stages. Here there is a lead period before projects are identified, evaluated and capital granted. And there is the gestation period of the project itself. So there is a period, from one to several years, where there is no yield at all on the investment. If an investor withdrew at this stage he will possibly sustain a loss. What would be even more unfair is that should another one come in at this point, he immediately starts with a claim to profit, which his predecessor would have been entitled to had he stayed on.

The above two cases point to the existence of two types of investment in Mudaraba. The former is Mudaraba Project Certificate and the latter is Mudaraba Certificate. In this case our original investor of the previous example would have been able to sell his shares to the second investor and thus receive some benefits for the period when his investment was not earning any profit.

Thus we can talk about Mudaraba Project Certificate and Mudaraba Certificate. The Mudaraba Project Certificate has some features like:

I. Mudaraba Project Certificates will not bear any fixed rate of return or interest,
II. The return will be determined at the end of each accounting period, and no attempt will be made to make any estimates in advance,
III. These are for a defined period, but they may be reinvested for another defined period,
IV. It has no priority claims over Mudaraba Certificates,
V. It shares in profit and loss, but they have no claims on the assets of the projects, and
VI. These are not transferable because there is no advantage.

On the other hand, Mudaraba Certificates are precisely the same as normal shares. These Certificates earn no profit or loss in the first few years, say one to three years and are transferable. Therefore these have no termination points. It will have a stake in the assets of the projects whereas the Mudaraba Project Certificates will not have any such claim. However, since the investors have no direct connection with any particular project, the claims of the Mudaraba Certificates are on all of the bank's Mudaraba operations. Thus, if for example, a project ends and the assets are sold off or the bank sells of its shares in a project (perhaps to the entrepreneur or to an outside investor) the proceeds from such sales will accrue to all the Mudaraba Certificates (providing intern dividends, additional Mudaraba shares or increasing their value).

Whether the Mudaraba Project Certificates and Mudaraba Certificate are issued periodically, as and when necessary or are available throughout the year; whether they are for fixed terms or not, are all operational concerns and are matters for bank's own decision. So is the decision as to whether the Mudaraba Project Certificates and Mudaraba Certificate have different profit ratio or the same. The bank may also consider issuing separate Mudaraba Project Certificate and Mudaraba Certificate to different groups of projects, instead of all the depositors having claims to all the projects of the bank.

3.5.4 Accounts and management

In the system described above, the bank is a full partner in all the projects it finances. Consequently, it has the right of access to all the books of the enterprise. It may have no say in the running of the enterprise as such – this is the exclusive domain of the entrepreneur, and the bank is not expected to have any expertise in the matter – but the accounts of the project are available to the bank at all times and it may step in[10] if any financial mismanagement or false accounting is discovered. This is to safeguard the interests of both the depositors and the bank, because if there is any loss both will suffer the consequences and the bank is accountable to both the depositors and its own share holders.

3.6 Application

All the writers on Islamic banking have advocated setting aside a portion of the bank's funds for "social" lending without any charges, and sometimes even writing them off when the recipient is unable to repay. While we do not intend to recommend charity on the part of a business entity handling other people's money, we do recognise the need for financing "social" projects. These are of particular importance to the society of Bangladesh. Since no cost-free money should be expected from the investment accounts of a commercial bank, we will explore ways of meeting both objectives.

The projects we have in mind are the ones that cater to the "basic" needs of the population in the rural areas and in the poorer sections of large towns and cities. Providing these needs will contribute to the local economy, create jobs in the locality and improve living conditions. In short, it is development at the micro level. These are the ones that lie between the non-profit making public services and enterprises, and the private enterprises with high profit expectations. This is the area where the government has no machinery to successfully implement them. Private entrepreneurs avoid them on account of their low expected turnovers and returns; their often-distant location away from centres of business activity also plays a part. But these are, however, the very areas which determine the level of economic and social welfare of the population. All political parties promise them but no government delivers them. This then becomes the domain of the entrepreneur both - individuals and organisations - with the public spirit and no money.

[10] *Foreclosure and/or money suit.*

If the talent and energy of such entrepreneurs can be coupled with the capital of the local investors through Islamic bank, then a major step would have been taken in the direction of national development. The fact that the local branches of Islamic banks are well aware of them and can conveniently assess and supervise them will be an added advantage. In addition, the local investors will have the satisfaction of seeing their money in useful action, perhaps even benefiting by it directly.

Examples of such projects are: farm and industrial equipment repairs and hires, local transport and communication, handicraft and cottage industries, marketing facilities for local produce, local shopping complex or market, low cost housing for the low and lower-middle classes, medical services including laboratory services, adult education and job training centres, etc. The list is varied and endless, and depends on the particular situation of the local community leaders and entrepreneurs, and the skills and resources available locally.

The common characteristics of these projects are that they are necessary for the economic and /or social development and well-being of the community, but the expected return on them is low, may take too long to bear fruit, and the local entrepreneurs willing to embark on such projects do not have the finances and even lack the necessary collateral to seek financing from the banks. The proposed Mudaraba financing scheme will work well because the projects itself becomes the collateral, the low return is augmented by the bank's money multiplier factor, and the long duration becomes less of a concern if the project has less risk and the return is constant. But the last two factors will, in addition, be mitigated by the bank also investing in other projects of lesser duration and higher profit. The proportion of investment account funds that will be earmarked for community projects and other private enterprise projects may be determined by the bank itself.

IV. Prospects of Mudaraba Financing Scheme

The Mudaraba financing scheme presented in the previous section offers great promises. But there are also concerns about its application in real life. Its promise lies first of all in providing a *halaal* way of earning an income using one’s capital without having to take an active part in an enterprise. Secondly, but equally importantly, it provides the entrepreneur access to required capital without having to deal in *riba.* In addition, this access to capital is made available without having to provide acceptable collateral. These are very important considerations. For there are many talented and skilled persons with experience whose initiative is frustrated because of their inability to obtain capital—either on account of their refusal to approach a bank for fear of dealing in *riba* or because they have no collateral. In the event it is the society as a whole that loses the fruits of their talent. The Mudaraba financing scheme seems to offer an excellent promise in preventing this situation.

We have so far limited our Mudaraba mode to be implemented through Islamic banks only. There are situations where this may not be possible. And even where possible, it may prove to be insufficient or unable to cater to all the demand. The first is when the banking authorities refuse to permit banks to get directly involved in such uncertain forms of investment, Islamic banks may not able or willing to provide Mudaraba financing. In this case, could the Mudaraba financing scheme be offered through intermediaries other than banks—as a substitute or as complementary? We will consider this in this section.

It appears that as the project size and its implication diminishes, it will become increasingly difficult to meet the costs of the intermediary. When the limit is reached, is it timed to revert to pure M*udaraba* partnership? We will look at this too. The possibility of offering the

Mudaraba through intermediaries other than banks seems to open great vistas. But what is the down side?

Returning to the commercial banks, assuming that they are allowed to offer Mudaraba as an option, what are the implications? The promises are more enchanting and the concerns more acute when Mudaraba financing is effected through commercial banks. There is promise that this will give additional impetus to local economic development. The primary concern is that this new form of financing by a commercial bank requires an altogether different approach to financing. Specifically, the officers entrusted with its implementation will have to have a very good understanding of the scheme, commitment to its success and, even more importantly, a good understanding of needs and opportunities in the area, the business climate and the people. In short, besides being good and prudent bankers they will have to be also entrepreneurs themselves. We will address these issues briefly here in below:

4.1 Intermediaries other than banks

The central feature of traditional banking is capital certainty for depositors. In Mudaraba financing there is no guarantee of capital for the investment depositors.

Referring to Islamic banking in the context of PLS schemes, Sir Leigh Pemberton[11], the Governor of the bank of England, told the Arab Banker's Association in London:

- A central feature of the banking system of the United Kingdom as enshrined in the legal framework is capital certainty for depositors. It is the most important feature which distinguished the banking sector from the other segments of the financial system;
- The Bank of England is not legally able to authorise, under the Banking Act, an institution which does not take deposits as defined under that Act.

Mr Charls Schotta,[12] the US Treasury Department specialist in regulatory issues, has remarked, "Any institution that wishes to use the word 'bank' in its title has to guarantee at least a zero rate of interest."

Any relaxation of this position is precluded because should a bank offering Mudaraba financing fail, for any reason at all, it would undermine the confidence in the whole financial system, with which it is inevitably identified. As Suratgar[13] puts it, "There could be potential dangers for the international system, where the failure of such an institution could bring with it the failure of other associated institutions, or of all the Western banking institutions which come closely tied to with such an operation."

The position is same in Bangladesh which operates under the traditional system of banking. The question is: shall Mudaraba financing be doomed in Bangladesh? The answer, happily, seems to be No. The Islamic facilities might be provided within other areas of the financial system without using a banking name.

This brings us to the possibility of offering Mudaraba financing through institutions, let us call them Investment Companies, which can offer the Mudaraba financing scheme we have developed.

4.2 Investment companies

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[11] *Pemberton (1984).*
[12] *Schotta (1985).*
[13] *Suratgar (1984).*

Bangladesh that allows Islamic banks to operate should have no objection to permitting Mudaraba financing to be offered through investment banks.

There is concern too. For, now that the control and supervision by the banking authorities is absent, the responsibility of operating a clean system and thereby winning the confidence and the funds of the investors falls squarely on the shoulders of the investment companies. They, of course, will have to operate under the relevant company laws, but winning the confidence of the public is another matter. Their operations will have to be transparent and subject to audit. The investment companies, in turn, will have to make sure that the projects they finance are viable and the accounting is true and accurate and the financial management is sound. Establishing these companies as public limited companies may help in these respects.

The competence and the integrity of the entrepreneur is of crucial importance. It is on the strength of the trust in the competence and the integrity of the entrepreneur that his projects was financed and its success, and even more importantly, the very future of the Mudaraba financing scheme itself, depends on the continued existence of this trust. It is important to remember that the failure of a single entrepreneur to live up to a high level of honesty in his transactions can be bad news for the whole scheme.

The investment companies be established as alternative to investment banks. In the process we have overcome the barrier of the banking authorities. However, these companies are expected to cater to large investors and large projects. Could we not make it available to smaller investors, smaller projects, and take it to the smaller communities as well?

4.3 Smaller investment companies

The investment companies be established on a smaller scale as private limited companies instead of as public limited companies. Then it will become possible to catering services to smaller investors and smaller projects under Mudaraba mode. This will have enormous implications for local level economic development.

In the previous chapter we conceived of a scheme whereby commercial bank would provide Mudaraba financing to smaller entrepreneurs at the local level. The smaller investment companies we have considered above should be able to offer an alternative where Mudaraba financing through commercial banks is not allowed, and to complement and co-exist where it is permitted.

There is a special advantage too in organising smaller investment companies, since they can be started and operated without much difficulty with the Mudaraba financing scheme. If they fail, the damage is minimal. If they succeed, then, with the experience and expertise acquired, and the confidence of the public gained, they can move up the ladder to become large and, eventually, convince the banking authorities and set as investment banks.

The concerns we saw in the previous section fully apply to these companies too. In fact, the concerns become even more worrying as the size of the companies and their projects become smaller, since as the size decreases the resources available to them to mount a proper accounting, auditing and financial management system may become insufficient.

In such a situation, the success of the scheme will become crucially dependent on the honesty and integrity of the entrepreneurs and the companies.

The projects expected to be financed by these investment companies are pure profit-motivated economic enterprises. And they have to make sufficient profits to make it attractive even when the profits are distributed among the three players – the investor, the company and the entrepreneur. As such, they should not be expected to engage in projects whose main aim is social development.

4.4 Pure Mudaraba Partnerships

As the project size decreases, the turnover and profit will decrease, and a point will be reached when it will no longer be possible to pay for the service of the intermediary nor the profit sufficient to make the three-way split. Such projects, naturally, will not be attractive to any investment company. Is that the limit of the Mudaraba financing mode? Yes, but it may also be the beginning of pure Mudaraba partnership, where the financier and the entrepreneur deal with each other directly, without the intermediary. Put in another way, Mudaraba financing begins where pure Mudaraba partnership leaves off. In fact, they are different sections of the same spectrum catering of reaching and serving the needs of the very locality of the partners.

Pure Mudaraba partnership is a person to person relationship, based on personal knowledge of the entrepreneur's capabilities and his honesty and integrity. Trust between the financier and the entrepreneur is the foundation on which such partnerships will be established and maintained or destroyed. If this Mudaraba partnership is revived and helped to flourish, it will take the dream of economic prosperity through equal recognition of, and reward for, capital and labour several steps closer to fruition.

4.5 Concerns about controls

We have stressed throughout this section the importance of the honesty and integrity of the partners in the scheme for its success. We developed the whole Mudaraba financing scheme as an alternative to financing by traditional interest-bearing investments and loans, on the assumption that Muslims - both as investors and as entrepreneurs - do not wish to deal in interest on account of their religious conviction and the fear of Allah. Such a Muslim is by definition honest and trustworthy. Therefore, if our assumption is correct, the scheme we have developed should necessarily succeed *Insha Allah*. Yet our dealings should be made transparent by proper accounting and auditing. This is necessary in order to ensure the continued existence of the trust, for trust unsupported by verifiable facts is still suspect. If our assumption does not exist in any given place or time, or in a particular case, then the scheme is destined to fail and should not be attempted.

4.6 Credit expansion and economic development

Development, especially economic development, requires money. And money, either you have it or you must borrow it. Leaving aside public development activities and concerning us with only private economic activities, the necessary capital can be raised from investors, creditors or the banks. The commercial banks provide capital in the form of loans and advances, and this is called bank credit. The economic development of a society is dependent, to a very large extent, on the availability of this bank credit to its business and entrepreneurial community. The fact that commercial banks can create credit and thereby make more “money” available than is otherwise possible, is an important factor in the economic development of any country.

The ultimate base for the total credit expansion capacity of the country as a whole is the reserve holdings of its central bank. However, this capacity is limited in practice by the circumstances in which the local commercial banks might find themselves. Specifically, they are constrained by four factors which are largely beyond their control but are dependent on the society they serve:

1. The size of the collateral available in the community that is acceptable to the banks;
2. The demand for credit;
3. The cash reserve ratio; and
4. The total legal tender (notes and coins and balances at the central bank) available to them as reserve.

The scheme we have proposed helps expand the availability of this bank credit by easing these constraints in several ways. We will see how these work when commercial banks finance projects by Mudaraba mode and Mudaraba financing enterprises are established.

4.7 Collateral

The new Mudaraba financing enterprises have been established (i.e. buildings, machinery and equipment, working capital etc. have been acquired) using bank money in a way money has been “lent” to the enterprise by the bank. Usually a commercial bank lends money to an enterprise or an individual only on the strength of collateral that the borrower provides, and the size of the loan depends on the value of the collateral. But money was “lent” to this Mudaraba financing enterprise not on the strength of any existing collateral but the assets of the new enterprise acquired using the bank’s “loan” itself has been pledged as collateral. In other words, the new Mudaraba financing enterprises, which did not exist before, themselves have become new collateral of bank's Mudaraba financing projects --- private enterprises as well as the social projects. Thus the Mudaraba financing scheme extends the capacity of the community to borrow by creating new collateral for such borrowing.

4.8 Demand for credit

The new enterprises were established using venture capital provided by the Mudaraba financing funds. But they will need further financing, including short-term advances, for various normal business operations, and this creates new demand for credit. The demand created by the new economic activity will be met by the bank’s existing reserves or it will seek and acquire additional reserves.

4.9 Cash reserve ratio

Both because the credit has to be drawn upon using cheques and because the Mudaraba financing scheme demands proper accounting, most of the transactions will take place through the bank. The prestige that goes with an enterprise that is financed by a bank - in fact where the bank is the main share holder – makes the enterprise’s cheques widely acceptable, enabling it to deal with creditors more easily and without having to always pay for in cash. All these previously non-existent cheque-based transactions will help the bank to expand its ability to supply credit. For, since less cash is used in the transactions, bank's cash reserve ratio could be lowered to that extent to enable more credit to be extended on the same cash base.

4.10 Reserves

The bank's capacity to extend credit is also enhanced buy the expansion of its cash base (reserves) in two ways. One, if the banks begin to show consistently good returns in their Mudaraba financing operations more people will bring in their savings to investment accounts. Two, the fact of seeing the Mudaraba financing projects helping their own local community - perhaps themselves too – directly may also encourage the local investors to bring in more of their capital and savings. Additionally, the fact that they can employ their capital and savings to earn an income without involving in interest dealings –as in a time or saving deposit account in a conventional bank—also will help bring in funds previously unavailable to the banking system.

4.11 Project size

We have already seen that the size of an enterprise is an important factor in deciding on the type of financing it requires. There are large-scale projects which require international or investment bank financing, and there are, at the other end of the spectrum, small one-man undertakings which are best financed by loans. Expected turnover of a project in the former category is capable of paying for all the financial and other services it uses up and to provide handsome returns to its many investors, while one in the latter category hardly needs, nor is it able to pay for, such services. The returns are often not much more than sufficient to provide for the entrepreneur himself and his family. The projects that should be considered for PLS financing by commercial banks lie somewhere in the middle of this large spectrum. The upper limit will be largely determined by the investment opportunities presented to the bank and its own capacity and willingness to take part in such projects. It is the lower end that should present some problem. To begin with, the project's turnover should be large enough to pay the salaries of those employed by the project, including the entrepreneur himself, and to pay for professional services such as accounting and auditing, which PLS financing necessarily requires, and the supervisory cost of the bank. On top of it, the project has to show sufficient profits to retain the current investment and to attract further investment. But if this consideration pushes the limit far high, all the social benefits envisaged by the Mudaraba financing modes will be lost, especially in the social projects.

Officers of the bank entrusted with making decisions on project financing will have to be fully aware of the conflicting interests and view them in proper perspective. General guidelines may be given by the top management but the managers directly responsible for recommending Mudaraba financing should consider each case on its own merit with due regard to local conditions.

4.12 Education and training

The Mudaraba financing mode developed here is an entirely new concept. It is new in theory and new to those who will eventually participate in it - bankers, entrepreneurs and the depositors. Therefore it is essential that it be fully understood by all concerned before any attempt is made at implementation. Both its philosophy and its practical aspects must be fully grasped. Bankers will have to develop methodologies and they have to, in turn, train their staff in their application. This will take time. Then potential entrepreneurs will have to be educated on the working of the scheme, the advantages and the obligations.

Finally potential depositors (investors) will have to be convinced that this new scheme has something to offer them.

Providing short courses in banking, literacy for potential customers and in book-keeping for potential entrepreneurs will help greatly in successfully implementing the mode. This, in turn, will go a long way in advancing national economic development. Perhaps government and banking authorities might consider some meaningful contribution in this area.

V. Implementation of Musharaka

The modern business concerns being run on the basis of Musharaka are as under:

1. **Partnership:** It is regulated by
   (a) Partnership rules framed by the government,
   (b) Business practices prevailing in the business community.

2. **Limited company**. This type of Musharaka is strictly controlled by the statutory rules framed by the government. Its commercial activities are, however, influenced by the business practices (***urf***).

3. **Co-operative societies**. This Musharaka is also governed by statutory rules. Its commercial activities are influenced by the practices prevailing in the business community.

The above modern Musharaka principally resembles Shirkah-al-Inan[14]. Let us discuss briefly the conditions of Musharaka, which are those of Shirkah-al-Inan. Other types of Musharaka mentioned by jurists are nearly obsolete nowadays.

5.1 Share in Capital:

Capital to be invested by the partners may be unequal. For the majority of the jurists the capital should be in the shape of currency and not in the shape of goods. In limited companies and co-operative societies the capital is invested in the form of equal units of currency called shares and the intended partners buy as many shares as they wish. This practice has universally been accepted as *urf* and is therefore according to Islamic principles.

5.2 Management:

Musharakah is run and managed by the will and equal rights of participation of all the partners. Different aspects of Musharaka business are as follows:

1. Every partner is an agent for the other, as all the partners benefit from the Musharaka business. When a contract of Musharaka is made the condition of agency is automatically presumed to be in existence in the contract. The actual possession of a partner over a property of the Musharaka business is considered as possession of other partners in as much as if a partner purchases half portion of a specific good for himself and half portion thereof for the Musharaka. When he takes possession of that specific good, this

[14] *Inan implies that all partners need not be adults or have an equal share in the capital. They are not equally responsible for the management of the business. Accordingly their shares in profits may be unequal, but this must be clearly specified in the partnership contract Their shares in losses would of course be in accordance with their capital contributions. Thus in shirkah al-inan the partners act as agents but not as sureties for their colleagues.*

possession will be considered as possession of all the partners. If, however, a partner purchases some goods for himself only, it is exclusively for him and not for the Musharaka business.

2. Every partner enjoys equal rights in all respects in the absence of any condition to the contrary.
3. Any condition regarding participation in and administration of the Musharaka and variation in the share of profit on this ground is valid. The contract of Musharaka is not invalid on grounds of a condition of non-participation in the Musharaka business, but on the ground that a share in the profit exists.
4. Every partner has a right to participate actively in the affairs of Musharaka if he/she wishes.

In all modern forms of Musharaka, the partners have equal rights as mentioned above. In the limited companies and cooperative societies the shareholders delegate their powers (rights in respect of administration etc.) to some among them to be called directors or given any other appropriate title. In a partnership concern the partners, by a mutual agreement, distribute among themselves their responsibilities, duties and jobs. As mentioned above these practices are valid being *urf* of business community.

5.3 Distribution of Profit:

The basis for entitlement to the profits of a Musharaka is capital, active participation in the Musharaka business and responsibility. Profits are to be distributed among the partners in business on the basis of proportions settled by them in advance. The share of every party in profit must be determined as a proportion or percentage. No fixed amount can be settled for any party[15].

Limited companies and co-operative societies distribute their profit according to the capital of shareholders. If any shareholder participates actively in these modern Musharaka he is paid for it and such payments are regarded as the expenditure of Musharaka. This is modern *urf* and there is nothing un-Islamic in this *urf*.

5.4 Liability of Loss:

All the jurists are, unanimously, of the view that the loss shall be borne by the partners according to their capitals. In all forms of Musharaka (i.e., limited companies, co-operative societies and partnership) the loss is borne on the basis of capital invested.

The jurists have categorically laid down that a party, which has no capital invested in an enterprise, does not have to share its loss. From the explanation of the jurists, it is clear that it is not possible, after investment of capital, to avoid the risk of loss in the enterprise. This is a direct consequence of the prohibition of interest in Islam. The jurists point out that this is because of the fact that loss means destruction of a part of the capital and hence, as it occurs, is a liability of the owner of capital alone.

However, according to modern commercial practices the loss does not cut down the respective capitals of the partners or share-holders, but remains as it is in the accounts books of the Musharaka in order to be adjusted against the future profits. It is pertinent to note that while adjusting the loss against future profits the accounting procedure automatically works in a manner so as to bear on the capitals subsequently.

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[15] *M.N. Siddiqi, Partnership and Profit Sharing in Islamic Law, The Islamic Foundation, Leicester, 1985, pp.22-23.*

5.5 Withdrawal of Members:

In the early days of Islam the Musharaka were generally formed on a short-term basis, mostly of a joint venture type. It was, therefore, quite easy for a partner to withdraw from a Musharaka. The withdrawal did not create many problems such as the taxation of capital expenditure, the continuous nature of business activities and goodwill. This is why the old jurists did not feel any need to impose restrictions on the withdrawal of a partner, but in the present complicated commercial practices, legal requirements and public control entangle a Musharaka for a considerable period so deeply and firmly that no partner or shareholder can be absolved of his liability as such. So according to a modern *urf* the shareholder of a limited company cannot withdraw from it and receive back his capital invested therein. He can, however, sell his share to any person desirous of becoming a shareholder of that company. In a partnership business a partner can be permitted to withdraw and receive his capital back after fulfilling his liabilities as a partner according to terms and conditions settled between the partners.

5.6 Limited Liability:

A distinguishing feature of modern Musharaka (except the partnership) is the limited liability of their shareholders. They cannot be held liable for more than the amount of capital they have invested. This requirement makes it necessary to regard the Musharaka as an entity separate from the individuality of the shareholders. This common *urf* has given way to safe and stable Musharaka resulting in big commercial organizations and flourishing business.

To sum up, the Shirkah-al-Inan, which implies unequal shares and is recognised by all schools, may tend to be the most popular. In this case, the profits are divided in accordance with a contractually agreed proportion, since the Shariah admits an entitlement to profit arising from a partner's contribution to any of the business assets. However, the Shariah makes it clear that losses are to be shared in proportion to the contribution made to capital. This is because losses constitute erosion in equity and must be charged to the capital. If a loss has been incurred in one period, it must be offset against profits in the subsequent periods until the entire loss has been written off and the capital sum restored to its original level. However, until the total loss has been written off, any distribution of "profit" will be considered as an advance to the partners. Accordingly, it would be desirable to build reserves from profits to offset any losses that may be incurred in the future.

It appears that Musharaka is a mode of PLS system like Mudaraba discussed in the previous sections. The finance may be provided by more persons but that makes no difference to the arguments of implementation of Musharaka like Mudaraba. It is believed, therefore, the proposed operating models of Mudaraba and Musharaka may be implemented in Bangladesh.

Conclusion

Mudaraba and Musharaka modes discussed in the forgoing are very promising but there are concerns too. These can be offered through investment companies as well. Larger size investors and larger size projects should be treated differently from their smaller counterparts. Financing social projects through Mudaraba and Musharaka by commercial banks is especially important on account of its immediate relevance to the majority of the people living in rural Bangladesh.

In order to bring about a riba-free economy, the country's banking system has to be riba-free, its commercial enterprises have to be financed by equity capital, and its investments have to be on a profit and loss sharing basis. The study has dealt with investment and financing, and has introduced a Mudaraba-based system called profit and loss sharing financing that takes into account present-day realities. This is a new institution specifically developed to address the concerns of Muslims. It has no parallel in the conventional economy, but the individual tools and techniques it uses are the ones, which may be tested and proved in the conventional setting. It is for the Muslim intellectuals, professionals, investors, entrepreneurs, and other concerned individuals, institutions and organizations to take up the challenge.

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