Issues and Challenges in Offering Muḍārabah and Mushārakah Products in Islamic Finance

(Isu dan Cabaran Penawaran Produk Mudarabah dan Musyarakah dalam Kewangan Islam)

Asmadi Mohamed Naim
Mahyuddin Abu Bakar
Muhamad Nasir Md. Hussein
Mohamad Noor Habibi Long
(Islamic Business School, Universiti Utara Malaysia)

ABSTRACT

The study aims to explore the views of scholars, bankers and entrepreneurs in promoting mudarabah and musharakah based contracts and to analyse their views to strengthening those practises. The study utilized qualitative research approach which consists of document analysis, interviews and observations in few phases. The study found few industrial concerns such as the needs on checks and balances in mudarabah and musharakah to avoid failure; the lacking of some good qualities and hence certain conditions must be imposed on entrepreneurs if they want to conduct business based on musharakah or mudarabah contracts. In addition, although all respondents agreed that the daman concept is actually contrary to the concept of mudarabah (muqtaḍa al-‘aḍ), they still stress the need for a mechanism to make entrepreneurs serious in conducting the business. However, the disappointing conclusion derived from the interviews is that the industry is quite reluctant to enhance their participation in mudarabah- and musharakah-based products.

Keywords: Mudārabah; mushārakah products; Islamic finance; daman; burden of proof

ABSTRAK

Kajian ini bertujuan untuk meninjau pandangan ulama, bank-bank dan usahawan dalam mempromosikan kontrak-kontrak yang berasaskan kepada mudarabah dan musyarakah, dan menganalisis pandangan mereka bagi mengukuhkan amalan tersebut. Kajian ini menggunakan pendekatan penyelidikan kualitatif yang terdiri daripada analisis dokumen, temu bual dan pemerhatian dalam beberapa fasa. Kajian mendapat terdapat kebimbangan industri dan industri menekankan kepelbagaian “sekat dan imbang” dalam mudarabah dan musyarakah untuk mengelakkan kegagalan; pengenaan beberapa syarat mesti dikenakan terhadap usahawan yang tidak mempunyai beberapa kualiti yang baik apabila mereka ingin menjalankan perniagaan berdasarkan kontrak musyarakah atau mudarabah. Di samping itu, walaupun semua responden bersetuju bahawa konsep daman bertentangan dengan konsep mudarabah (muqtaḍa al-‘aḍ), mereka menekankan perlunya satu mekanisme untuk memastikan usahawan serius dan berhati-hati menjalankan perniagaan. Walau bagaimanapun, ranusan yang mencekalan diperolehi daripada temu bual tersebut ialah industri agak keberatan untuk meningkatkan penyiapannya mereka dalam produk berasaskan mudārabah dan musyārakah.

Kata kunci: Muḍārabah; produk mushārakah; kewangan Islam; daman; beban bukti

INTRODUCTION

In the wake of the vast development of Islamic finance over the last few decades, much has been said about the limited track record of Islamic financial institutions (IFIs) applying risk sharing principles, especially mudārabah and mushārakah. The data of Bank Negara Malaysia in 2016 shows that the combination of financing by concepts of Islamic banks amounted to the total of RM390 billion. The issues of high risk in general and multi-faceted business risks in particular that are associated with mudārabah and mushārakah became the main obstacle in the implementation. To minimize these risks, scholars have prescribed proper guidelines such as on taqṣīr (negligence) and ta‘addi (transgression). Discussion of the concepts of taqṣīr, ta‘addi guarantee and the management of moral hazard in mudārabah and mushārakah products are paramount in realizing their implementation.

PROBLEM STATEMENT

One major problem with the profit and loss sharing (PLS) contracts that has been frequently mentioned in the literature is the agency problem, which is said to be inherent to these types of contracts. For example, in the words of the State Bank of Pakistan 2008, “The agency problem is one of the major factors for the reluctance on the part of banks to undertake equity based modes of financing, as it gives entrepreneurs the incentive to under-state profits.” (Kazarian 1993; Rickwood & Murinde 2002; Dár & Presley 2000; Iqbal & Molyneux 2005).
Ashraf and Lokmanul (2011), after noting the moral hazard of customers reporting losses in their financial statements in order to avoid paying the rabb al-māl, suggested that IFIs in mudārābah and mushārakah arrangements may require customers to prove their integrity in order to protect the IFIs’ position. Part of the due diligence process when applying for mudārābah financing involves feasibility studies. Financing will not be approved unless the proposed project is determined to have a good probability of being profitable. The occurrence of loss raises the very real possibility that the customer was negligent. Hence, such customers have a responsibility to prove that they are not guilty.

However, this view seems to contradict the stance of Shariah from a few aspects. First, the Islamic legal maxim states: al-aṣl barā’ at al-dhimmah (freedom from liability is the pre-existing and therefore prevailing state). Second, mudārābah is a trust-based contract; the entrepreneur holds the capital provider’s fund under the principle of trust. Requiring the entrepreneur to prove his innocence means that he is presumed guilty unless he provides evidence to the contrary, which may contradict the essence of the mudārābah contract.

All of these highlights the need to analyse the issues in detail in order to uphold the appropriate view related to the essence of both contracts and the limitation that a guarantee can be implemented in partnership contracts. In addition, comprehensive views from practitioners, scholars and entrepreneurs are very much needed to strengthen this practice and to understand the challenges in promoting these concepts.

OBJECTIVES

The objectives of this study are to explore the views of scholars, bankers, and entrepreneurs in promoting mudārābah and mushārakah based contracts and to analyse their views in order to strengthen these practises.

LITERATURE REVIEW

Hassan and Mehmud (2008) said that mudārābah contains many risks, particularly business risks. They insisted that managing a business has its own risks and that Islamic banks need to face these risks. Among other risks inherent to mudārābah are the business partner’s freedom to terminate the partnership at any time, which will definitely cause the business to be liquidated because no one can be forced to continue a partnership against his/her will. Given this reality, many Islamic banks avoid unnecessary exposure to mudārābah risk. However, a few studies revealed that some anxieties, such as the withdrawal of investors, have been overcome by the existing structure of the mudārābah contract. Based on the decisions of the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) as stated in Shariah Standard 2010, Standard 13, Section 4, which affirms that the mudārābah contract is not binding (ghayr lâzim) and that each contracting party is free to withdraw except in two situations:

1. The mudārīb has started the work; as soon as that happens the mudārābah becomes binding until the occurrence of liquidation (tandīf), either actual (haqīqī) or constructive (hukmī).
2. If the two sides have agreed to stipulate a term for the mudārābah, it cannot be dissolved before the due date except with the consent of both parties.

If an Islamic bank enters into a partnership in which the managing partner cannot be held responsible for any operational losses, it means that the Islamic bank cannot collateralize the risk. Therefore the mudārābah structure of equity finance becomes riskier for the Islamic banks. In fact, it is listed as the fifth risky type of financing in terms of credit risk (Khan & Ahmed 2001). Moreover, Islamic banks as financial intermediaries have to undertake the process of project evaluation, which is very long and costly. The expertise that is needed for the decision process is complicated.

Several authors have come up with a number of solutions in order to make PLS contracts more appealing to IFIs. Bacha (1997) proposed that the mudārīb must ‘reimburse’ the rabb al-māl in the event of certain outcomes. Karim (2000) recommended that the mudārīb contribute some capital or collateral in the project. Adnan and Muhammad (in Obaidullah 2008) argued that while cases of mudārīb negligence leading to losses are taken care of in mudārābah, proper systems should evolve to establish such negligence and ascribe the losses to the mudārīb. Khan (2003) suggested that banks guarantee investment deposits by tabarru’ to minimize the agency problem.

A few papers were presented on this topic at the Fifth Regional Shariah Scholars Dialogue in Phuket, Thailand in 2011. Ashraf and Lokmanul (2011) emphasized that the view of the majority of scholars prohibiting a guarantee in mudārābah is the strongest opinion. However, they said that stipulating a guarantee in mudārābah using the same basis as in the imposition of liability on artisans and on those offering their labor to the general public (tadmīn al-sunnā’ and al-aqrār al-muṣhtarāk) seems acceptable in order to protect public interest (maṣlaḥah ‘ammah) against the loss of wealth, especially in a time when dishonesty has become typical behavior.

Reflecting on the view above, this study observes that the guarantee element in both issues, i.e., tadmīn al-sunnā’ and al-aqrār al-muṣhtarāk, does not change the nature of either contract. Each is inclined to be categorized as damān al-ṣāfī (liability due to possession) or damān al-mulūḏī (indemnity for damage). Therefore, the guarantee should be allowed in both cases as no element of qardh and ribā appears in them. However, the case is different in a mudārābah contract, as the
arrangement in mudārabah is providing money against a portion of the profit. Therefore, any guarantee element shall transform the contract into a qard contract. Hence, the guarantee element has changed the essential nature of mudārabah (muqtaḍā al-aqḍ). Therefore, any measures to protect the investors (rabb al-māl) should observe these matters. Steps in that direction are still possible as long as the efforts do not exceed the boundaries of mudārabah's essential nature.

Ashraf and Lokmanul (2011: 16-17) then suggested that mudārabah contracts with small and medium industries should be treated on the basis that they are liable for the capital in the event of loss, unless they are able to prove that they were free from any negligence or irregularities in the management of the capital. The authors then gave the justifications for this view and suggested maintaining the original rules of mudārabah for strong companies.

This research is of the view that the nature (muqtaḍā) of mudārabah has been changed to damān when the losses are placed directly on the entrepreneur. Whenever the nature of mudārabah has been shifted to a guarantee-based contract, the rabb al-māl is permitted to take collateral against any loss. In addition, the nature of mudārabah becomes similar to qard. Furthermore, the entrepreneurs then have to fight to prove their innocence.

Another issue that may arise is to whom they have to prove it. This needs to be proven in court, which consumes a lot of time and money. Assigning the rabb al-māl the right to determine wrongdoing is hardly likely to result in an objective and impartial judgment. Notwithstanding these complications, this research is interested in the idea of developing an instrument to enable the rabb al-māl to get compensation if entrepreneur negligence and misconduct do occur.

Adiwarmann (2011) also emphasizes the element of security or collateral in mudārabah financing as practiced by Islamic banks in Indonesia. In their implementations, the mudārabah contract is maintained as a trust contract, but the financier (bank) is allowed to impose collateral against any customer negligence or misconduct.

This practice is supported by AAOIFI in Shariah Standard No. 13, Section 6, which allows the placement of such securities by stating:

The capital provider is permitted to obtain guarantees from the mudārib that are adequate and enforceable on condition that the capital provider will not enforce these guarantees except in cases of misconduct, negligence or breach of contract on the part of the mudārib.

However, Adiwarmann did not mention when the collateral will be used to claim compensation for clients and customers. Does the practice of the banks genuinely compensate the capital provider regarding the negligence or misconduct of the entrepreneur, or are there cases where they liquidate the collateral against losses not resulting from negligence and misconduct?

Furthermore, who will determine that the entrepreneurs have committed negligence and misconduct in their actions? Can the bank alone decide on the matter? If the bank is the only party that can determine whether entrepreneurs have committed negligence or misconduct, is it fair to customers to have their fate determined by the financiers? Who then will examine the moral hazard of the financier (rabb al-māl) determining customers' negligence?

THE PROBLEM OF CAPITAL AND MUQTAḌĀ AL-'AQD

Azman and Zaharuddin (2011), like Ashraf and Lokmanul (2011), have chosen the majority view of scholars that does not allow the element of guarantee in trust-based contracts such as mudārabah and mushārahkāh, except if there is an element of ta'addī and taqṣīr. However, the authors raised several other issues that could be classified as controversial.

Azman and Zaharuddin (2011) cited the views of some contemporary scholars about the types of ta'addī; for example, Hussein and Abdul Hamid al-Ba'li proposed that if that mudārib has done feasibility studies and the investment results differ from the projections of the study, the mudārib should be considered to have committed negligence and misconduct in his operations. In addition, the case can be analogized with the case of al-taqrīr bi al-fi'l (deceiving by deeds). Here, as in Ashraf and Lokmanul (2011) view, it is the responsibility of the mudārib to prove that the failure to achieve profitability as in the feasibility studies is not due to his negligence.

The view of Hussein Hamid and al-Ba’li places too much weight on the feasibility study as a criterion for honesty; equating honesty with profit and dishonesty with loss. Interviews with the entrepreneurs showed that the feasibility study is not a primary factor of success or a very reliable predictor of it. On the other hand, the view of Ashraf and Lokmanul (2011) may be more suitable to protect the capital owner. Azman and Zaharuddin (2011) also appeared to agree with Hussein Hamid in allowing liability for ta’addī to cover submission of all the mudārabah assets to the rabb al-māl even if the mudārabah assets exceed the capital costs. This view is intended to prevent the mudārib from committing ta’addī in situations in which the value of the assets rise during the course of the mudārabah venture, which may motivate him to liquidate the mudārabah assets, return the capital back to the rabb al-māl, and pocket the difference.

However, this view does not recognize the increased value of company properties as a profit that reflects the mudārib’s good management through smart purchasing strategies. Therefore, it is more preferable if both parties should share accordingly any amount above the capital amount. Furthermore, this view may not be feasible in mushārahkāh in which the IIF provides part of the working capital that is used to bear the operating costs. In this kind
of mushārakah, the determination of profit is settled after calculating the overall profit of the company’s operations. In the event of ta’addi, the mushārīk seems to be a guarantor and liable to repay the investment by surrendering all of the company’s assets. It seems unfair to the mushārīk when mushārakah puts profit-sharing as a major requirement.

Aznan and Zaharuddin (2011) stressed that some past scholars such as al-Shawkānī (1998) and Ibn Taymiyyah (2001) and recent scholars such as Ḥammād (2011) allow the stipulation of damān upon the muḍārib or mushārīk. This study humbly offers a contrasting view from that of Aznan and Zaharuddin (2011) in their interpretation of Ibn Taymiyyah’s view, which they understand to support the permissibility of holding the muḍārib or the mushārīk liable. The differing interpretations of Ibn Taymiyyah’s (2001) statements will be discussed in detail in section 3.4.1 on the essential nature of muḍārabah.

Although Ḥammād (2011) also upheld the non-guarantee element of muḍārabah, he is inclined towards shifting the burden of proof in disputes over profit shortfalls to the entrepreneur (muḍārib), i.e., he would have to prove that he had not been negligent and had not engaged in misconduct.

Based on what was discussed, the weightier opinion, in my view, is the permissibility of stipulating liability (damān) on fiduciaries (umānā). It is valid and binding as long as the stipulation does not empty the trust contract [of its content] and strip it of its true nature (in Aznan & Zaharuddin 2011).

A few writers before Ḥammād (2011) explored muḍārabah and mushārakah contracts. For instance, Taqi Usmani (2005: 38-40) discussed in detail current Islamic finance practices, including muḍārabah and mushārakah. He called attention to the element of capital guarantee in mushārakah mutanāqīṣah as presenting a possible issue of Shariah non-compliance in the arrangement.

ʿAbd al-Mujāliḥ and Ḥamdān (2005) also explored muḍārabah and mushārakah contracts and related them to the practices of Islamic financial institutions. A few elements of his explanation may help in the present discussion. Al-Khuyatīr (1999) discussed muḍārabah in his book using the normal method of comparative fiqh study without any relation to Islamic finance. Perhaps this was because Islamic finance was still a relatively new phenomenon at that time. However, he did touch upon a few relevant issues related to this study, such as the nature of the muḍārabah contract, the capital contribution, negligence and misconduct, among others.

Al-Dabb (1998) explored muḍārabah within the scope of Islamic economics. He compared the view of the Shariah on muḍārabah with the existing law of his country, Jordan. He too elaborated a few issues relevant to this study. A number of studies have explored the issues of damān, taqṣīr and ta’addi in some details. Māyīshā Kamāl (2009) touched upon the issues of taqṣīr, īrāq and ta’addi and the consequence of those acts, including damān.

Al-ʿAnzī (2009) wrote clearly and systematically about compensation conditions in contracts. He discussed taqṣīr and ta’addi as well as the ways to compensate for those acts. Al-Khaṭīf (1981) wrote a valuable book on damān in Islamic jurisprudence. He differentiated between contracts whose nature is guarantee and situations where a partner is liable (damān) because of his acts without transforming the contract into a guarantee-based contract.

To conclude the literature review, based on the discussion above, there are certain issues that do not require further debate, such as:

1. Jurists’ views on muḍārabah and mushārakah;
2. The evidence for the legality of muḍārabah and mushārakah.

However, a brief discussion of these topics is still relevant for maintaining an orderly presentation of the concept under discussion. After analyzing the works cited, it is very clear that a few topics require further discussion; for example:

1. Issues related to muṣṭaḍā al-ʿaqd in muḍārabah and mushārakah;
2. Types of actions that can be considered from an Islamic point of view as taqṣīr or ta’addi;
3. Elements of security and guarantee in muḍārabah and mushārakah that are permissible as long as they do not change the essence of muḍārabah and mushārakah;
4. The contention that placing the burden of proof on the muḍārib or mushārīk does not transform the muḍārabah or mushārakah into a guarantee-based contract.

METHODOLOGY

This research applies qualitative research approaches, in which according to Marvasti (2004) “the qualitative research provides detailed description and analysis of the quality, or the substance, of the human experience”.

In choosing the research method, the nature of the data required and the practical constraints of the study must be considered. The best method employed is that which meets the research objectives and answers the research questions (Darlington & Scott 2002). In order to find out the issues and challenges in offering muḍārabah and mushārakah products in Islamic finance by Islamic banks in Malaysia, this study employs qualitative research technique, specifically in the form of content analysis of literature and in-depth interviews.

In the first phase, the study collected data from libraries in the form of related books, journals and other publications, and from recognized Internet websites pertinent to the issues related to the research objectives: inter alia, Islamic principles and concepts related to Islamic law, and standards and guidelines on finance and the banking industry. The researchers were also engaged
in various industry talks in order to further understand the subjects of the study.

In the second phase, the researchers had interviewed a few Shariah advisors to explore their views on the discussed matters. Effort was then made to determine which of their views are the most relevant and justifiable. According to Sousluksi and Lawrence (2008), a population (Shariah advisors) is selected because they are considered good sources of information that will advance the study towards a reasonable goal. This method entails the researcher selecting relevant respondents based on his prior knowledge of the population in order to meet specific study objectives. The sample size is not a concern, as Robson (2002) noted that there is no set number of interviews needed for a flexible design study.

Face-to-face interviews were meant to seek and thoroughly discuss the practices and issues regarding the matter under discussion. The respondents were selected by using snowball and purposive sampling techniques (Silverman 2000; Neuman 2003). Every interview was conducted for approximately 90 minutes, and each was recorded and transcribed for analysis.

In addition, this study applies the method of ethnography interviewing in which ethnography focuses on what are the activities in order to understand the complex behavior without strategy that limits the inquiry. It is not necessarily a structured interview (Othman Lebar 2007: 95). The ethnographic interview method allows researchers to assist respondents towards the answer to suggest the reasons behind the practices, since ethnography interviewing includes conducting a series of friendly conversations where the interviewer to slowly introduce new elements to assist participants to respond to the questions. Hence this study has chosen a closed, fixed-response interview where all interviewees were asked the same type of questions and asked to choose answers from among the same set of alternatives (Othman Lebar 2007: 121).

This type of study has few features such as a strong emphasis on exploring, or it has a tendency to work primarily with “unstructured” data. It is also beneficial in investigating a small number of cases and can be used to analyse verbal descriptions and explanations. The researcher also observed the practices through informal conversation with bankers and Shariah officers.

To check the validity and the reliability of the questions, the researcher conducted pilot interviews with four experts to get their views on the content of the questionnaire. As a result, the questions were amended in accordance with the recommendations to ensure appropriateness and clarity.

**EXPERT VIEWS ON IMPLEMENTATION OF MUDÀRABA- AND MUSHÀRAKAH-BASED PRODUCTS**

This section highlights the views of industry players, practising Shariah scholars and entrepreneurs, which were elicited from interviews with a selected number of them. The section is divided into two parts: first, the views of players in the Islamic finance industry and entrepreneurs; and second, the views of a few Shariah scholars who have been appointed as Shariah committee members in a few Islamic banks, and the views of entrepreneurs on questions related to them.

The interviews were conducted in four Islamic banks: Maybank Islamic, Hong Leong Islamic Bank, Standard Chartered Saadig Bank and Kuwait Finance House. However, to avoid any confidentiality issues, the participating banks were renamed as Bank A, Bank B, Bank C and Bank D, in no particular order. The respondents of the banks consist of high managerial posts which includes Head of Shariah and Vice Presidents of the banks. As for entrepreneurs, interviews were conducted with a few Bumiputera small and medium entrepreneurs.

For the second part of the study five scholars were interviewed in order to get in-depth views regarding these issues. They were Asraf, Hidayat, Joni, Sobri and Azizi. As the approach of this study is to avoid any discomfiture to the interviewees, their names have been changed to Respondent A, B, C, D and E without following the sequence of their names as mentioned above.

**BANKERS’ AND ENTREPRENEURS’ VIEWS ON IMPLEMENTATION OF MUDÀRABA- AND MUSHÀRAKAH-BASED PRODUCTS**

A couple of banks, i.e. Bank A and Bank B, are interested in implementing the mudàraba and mushàrakah concept in Islamic banking system. However, Bank C is seen to be careful in stating its stance though its view is very close to the views of Bank A and B. The reason given by the Bank C is that the infrastructure of banks in Malaysia still depends on the conventional banking landscape. Therefore, Bank C suggested that the percentage of profit would need to be higher if the mudàraba contract were to be implemented.

In contrast, the remaining bank, i.e. Bank D, explicitly informed that it has no interest in implementing the mudàraba concept due to the issue of trustworthiness between the bank and its customers. The main reason given is that, in the event of loss, only the investor (the bank) will bear the loss. Therefore, the bank should ensure and strengthen the monitoring process carefully in mudàraba to avoid losses, and the bank found that such monitoring is not an easy task.

On the other hand, entrepreneurs expressed their interest in implementation of mushàrakah and mudàraba concepts in the Malaysian banking system. However, they agreed that the integral issue in mudàraba and mushàrakah is trust. They agreed that the current entrepreneurs lack sufficient good qualities. Therefore, surprisingly, they support the imposition of particular conditions on entrepreneurs if they want to conduct business using mushàrakah or mudàraba contracts.
THE RISK-SHARING ELEMENT IN MUDÁRABA

On the issue of whether investors are ready to face risks, based on the hadith of al-kharāj bi al-damān (“Benefit goes with liability”), Banks A and B responded that they were of the view that the concept of damān (guarantee) in a mudārāmah contract would turn it into a conventional (ribā-based) contract.

Regarding determination of the profits, Bank A agreed that the rate of profit should be based on the initial agreement. Although it was seen as more favorable to the customer, the operating profit rate in the Islamic banking system must follow the policy of the Central Bank, which means it cannot be much different from other banks, including the conventional ones.

**DAMĀN (GUARANTEE) CONCEPT IN MUDÁRABA**

The banks differed in their views about using damān (guarantee/collateral) for capital security in business activities. Bank D responded on this issue by saying that the damān concept is actually contrary to the philosophy or the muḍātādil al-‘aḍād al-mudārābah. Therefore, any imposition of liability on the entrepreneur in the mudārābah contract transforms the contract to a debt-based contract, i.e., conventional financing.

Surprisingly, the entrepreneurs stressed that the entrepreneurs should be liable for the funds in order to ensure that they are serious in conducting the business. It seems that they uphold the concept of liability on the entrepreneurs and that it is integral in order to ensure entrepreneurs’ prudence and commitment to the success of the business. In the meantime, they agreed that the concept of liability contradicts the essence of mudārābah and mushārakah.

**DAMĀN NEGATE RISK TO THE CAPITAL PROVIDER**

Most of the banks were not in a mood to respond to this issue. However, Bank D was very emphatic in rejecting the rule of damān in mudārābah. The entrepreneurs were of the view that when they are being held liable they will take things seriously.

**RISK MITIGATION**

Bank A has a method to reduce the risk in mudārābah and mushārakah. Although this bank has begun to offer mushārakah mutanāqīṣah over the last three years, it had a fairly consistent method to filter applications by investigating the developers’ track record on business activities.

Similarly, Bank B has a method to assess and evaluate the company, and this process has become a standard for decision making. In addition it also has a dedicated team to assess any application, and this has become a key factor in making the bank successful in the few mudārābah and mushārakah ventures that it has undertaken. According to the officers, the team conducts site visits and checks the prospective partner’s track record. Moreover, this kind of project typically has guarantees from the government or from GLCs.

Bank D proposed a relatively proactive method to reduce the risk by creating subsidiaries to operate mudārābah products for the bank. This method is likely to reduce the risk faced by the bank due to the high risk it poses.

Bank A found that the government already has a controlling mechanism for the collateral and securities issues to manage the risk in the mushārakah mutanāqīṣah such as the Housing Guarantee Scheme (SJPP). The bank will finance 100% of the home financing amount under the SJPP. Bank A also proposed giving a business’s rebate to the borrower if they belong to the zakāh-recipient category of overburdened debtors (ghārimin) by using zakāh money.

In terms of practice, Bank C has adopted hybrid products (mudārābah + mushārakah) in which the customer is considered the rabb al-mal and gives money to the bank, and the customer bears responsibility for any losses.

In mitigating the risk, entrepreneurs suggested that the capital owner should do the evaluation process more frequently and that the entrepreneurs be required to disclose all activities on an ongoing basis. Besides that, it was proposed that the owner conduct periodic evaluation and a regular monitoring process.

In addition, they agreed that stipulations can be used to reduce risk; for example, prohibiting or restricting the entrepreneur from going out of the country for a long period for a holiday or any other reason, which may have a negative impact on the business.

**TAQṣĪR (NEGLIGENCE) AND TA`ADDĪ (MISCONDUCT)**

AAOIFI’s Shariah Board has agreed that the capital provider may demand collateral against taqṣīr and ta`addī in mudārābah. The Shariah experts agreed with this view. In line with that, the entrepreneurs also agreed and stressed that collateral is a must when dealing with a large amount of capital.

**THE MEANING OF TAQṢĪR**

Banks A and B concentrate on the implementation of mudārābah in home financing, and they agreed to the view that taqṣīr refers to a situation where the partner is unable to complete the construction of the house as stated in the agreement and the construction is abandoned. In determining the role of feasibility studies, the entrepreneurs all disagreed with the suggestion that the failure to meet the expectation should be deemed negligence or misconduct. They felt the need to have a parameter on taqṣīr and ta`addī that identifies specific acts as either taqṣīr or ta`addī, and that this list can be used in court as a basis for judgment.
RISK AS A MAIN CONSTRAINT FOR THE BANK TO IMPLEMENT MUDÄRA Bah OR MUSHÄRAK At CONTRACTS

All banks agreed that risk remains a major factor deterring the implementation of mudärabah- and mushärakah-based products. Banks C and D stated that there is a very high degree of risk for such products. According to the International Islamic Financial Service Board (IIFSb), the risk-weighted rate can rise to 400% for both types of contracts.

LEGAL BARRIERS IN MALAYSIA

There are a few constraints that the Islamic banking system is facing in terms of legal barriers:

1. The infrastructure of banks in Malaysia is based on the conventional system.
2. Central banks worldwide are following Basel, which presents particular difficulties for Islamic banks since its requirements are derived from the conventional system.
3. Trade-based transactions need thick legal documents, which may consist of 500 pages, to comply with all the Shariah requirements.

THE STAKEHOLDER BARRIER

The industry players mentioned a few barriers to implementing mudärabah- and mushärakah-based products:

1. Investors prefer low-risk products; however, Islamic banks' mudärabah-based products are very risky. Definitely they will opt to go to conventional banks.
2. The existing bank infrastructure in Malaysia is conventionally based. To implement the mudärabah and mushärakah contracts, the banks will need some support from the government to enable this type of contract to be competitive with existing conventional loans.
3. The customer perspective whenever they come to the bank is to apply for a loan; they are not seeking to conduct a business with the bank through mudärabah or mushärakah. Banks cannot be expected to provide products for which there is no demand.
4. In order to comply with Shariah and legal requirements, the Standard Operating Procedure (SOP) in mudärabah is too overwhelmingly difficult to follow. So there must be a clear framework from the Central Bank, and the findings of academic research and industry experience must be used to come up with ideas and energy to prepare an action plan for implementation.

OTHER CONSTRAINTS

A few other constraints that banks face in implementing mudärabah-based products are as follows:

1. High risk involved because the bank is only an inactive partner with no management role in the business.
2. The abovementioned difficulty has led banks to implement measures in the operating procedure of mudärabah that render its fiqh characterisation ambiguous. For example, in Sudan, bank representatives are stationed in the factories and involved with business activities in order to monitor daily operation of the business.
3. Banks lack stringent evaluation policies to scrutinize the mdärī’s risk profile and other attributes to ensure that he would be a good potential partner.

INCENTIVES EXPECTED FROM GOVERNMENT

The banks offered a few suggestions in order to expedite the implementation of mudärabah- and mushärakah-based products:

1. The government should help to implement the mudärabah and mushärakah products by developing and approving new products in a more interesting way.
2. A few banks suggested that Islamic banks establish special entities to offer such products and that the Central Bank provide special incentives to promote such initiatives.
3. Other incentives should be considered for offering mudärabah- and mushärakah-based products.

RESPONSES OF SHARIAH EXPERTS ON MUDÄRA Bah, MUSHÄRAK Ah And Taqšīr AND Ta`addī

Five Shariah experts directly involved in the industry as Shariah advisors in Islamic banks were interviewed for this study on a few themes and their responses are in the following table:
<table>
<thead>
<tr>
<th>Theme</th>
<th>Respondent</th>
<th>Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>The content of <em>muqādalāt al-aqḍ</em></td>
<td>All scholars</td>
<td>It must consists all elements of contract.</td>
</tr>
<tr>
<td>ʿAmmān al-mudārib (Guarantee by partners)</td>
<td>All scholars</td>
<td>Disagreed. The basic structure of <em>muḍārah</em> must be maintained; the capital provider has to bear the risk and share the profit with the entrepreneur, and the entrepreneur has to bear the risk of losing his effort.</td>
</tr>
<tr>
<td>Risk sharing</td>
<td>Few respondents</td>
<td>They stressed the importance of good intention in implementing this kind of contract and the need to avoid trying to change its essential nature.</td>
</tr>
<tr>
<td><em>Damān al-mushārīk</em> (Guarantee by partners)</td>
<td>All scholars</td>
<td>Disagreed</td>
</tr>
<tr>
<td>Risk mitigation</td>
<td>All scholars</td>
<td>The <em>ḥaddik al-kharāj bi damān</em> (benefit goes with liability) and <em>al-ghum bi al-ghum</em> (liability accompanies gain) require that the capital providers should bear the risk to the capital; however, their responsibility should be accompanied with Standard Operating Procedures (SOP).</td>
</tr>
<tr>
<td>The issue of imposing <em>damān</em> on the entrepreneur,</td>
<td>Majority</td>
<td>Disagreed</td>
</tr>
<tr>
<td></td>
<td>One respondent</td>
<td>It does not contradict with the essence of <em>muḍārah</em> if there is an urgent need in accord with <em>maslaḥah</em> and to avoid harm; however, he proposes that the contract be given a different name such as <em>muḍārah bi al-damān, hibah bi al-shurṭ, bayʿ al-wafāʿ</em> and others.</td>
</tr>
<tr>
<td>Failure to fulfil the expectation of the feasibility studies</td>
<td>All scholars</td>
<td>It is permissible to impose collateral against <em>taqṣīr</em> and <em>taʿaddī</em> in <em>muḍārah</em> and <em>mushārakah</em> as upheld by AAOIFI.</td>
</tr>
<tr>
<td>Requirement to disclose his position in order to defend himself against any accusation that he has committed negligence or misconduct.</td>
<td>Few of scholars</td>
<td>The court is the appropriate party to resolve the issue of negligence and misconduct.</td>
</tr>
<tr>
<td></td>
<td>Few others</td>
<td>The court is the right party to determine negligence and misconduct.</td>
</tr>
<tr>
<td>The need to the parameters on <em>taqṣīr</em> and <em>taʿaddī</em></td>
<td>All scholars</td>
<td>Agreed.</td>
</tr>
</tbody>
</table>
| Acts classified as *Taqṣīr* | All scholars | 1. Payment made without following the SOP.  
2. Failure to check the received items; any defect in them after such failure is a proof of *taqṣīr*.  
3. Carelessness in properly documenting the transactions.  
4. Careless in managing the business by doing other than what he was supposed to do.  
5. Making changes without proper planning and evidence.  
6. Failure in observing legal requirements.  
7. Depending on a non-licensed supplier.  
8. Careless in management.  
9. Making a bad loan by providing a credit sale to someone who is not entitled to it; or entering a deferred payment contract with a supplier on non-standard terms and conditions.  
10. No contingency planning. |
They suggested a few proposals for the Islamic finance industry as follows:

1. No guarantee of capital and profit should be given for mudārakah and mushārakah financing against causes other than taqṣīr or ta‘addī.
2. The guarantee should be meant to protect the capital in the event of taqṣīr or ta‘addī.
3. The obligation to prove non-occurrence of taqṣīr and ta‘addī should be derived from a binding promise (wa‘d mu‘ālim) on the part of the entrepreneur. Any failure to prove the fact may result in liquidation of the collateral by the bank.
4. An independent third party is the appropriate party to decide on the occurrence of negligence or misconduct.

**SUGGESTIONS**

It seems that they uphold the concept of liability on the entrepreneurs and that it should be an integral part of the arrangement in order to ensure that entrepreneurs act prudently and are truly committed to the outcome of the business. Entrepreneurs themselves stressed that the businessmen cannot realistically be expected to perform their best without liability for the capital.

**BURDEN OF PROOF ON THE ENTREPRENEURS IN MUDĀRABAH OR ACTIVE PARTNER IN MUSHĀRAKAH**

With regards to the need for checks and balances, they have no serious objection to the concept of imposing upon entrepreneurs the responsibility to disclose their activities. It is apparent to the authors that there is no prohibition to requiring the entrepreneur in a trust contract to prove lack of guilt and requiring him/her to provide proper disclosure of his/her business management as long as there is no element of ribā in such a contract.

**ANALYSIS OF THE INTERVIEWS, FINDINGS AND CONCLUSION**

The conclusions with regard to the complexity to mudārakah and mushārakah in term of risk appetite, moral hazard problem and efforts to overcome moral hazard as discussed before, and in tandem with promoting the practices of mudārakah and mushārakah concepts in Islamic banking industry, the following are some salient points derived from the above mentioned interviews.

**THE NECESSITY OF CHECKS AND BALANCES IN MUDĀRABAH AND MUSHĀRAKAH TO AVOID FAILURE**

All respondents accepted the necessity of checks and balances. They also agreed that the current entrepreneurs are lacking in some good qualities and hence certain conditions must be imposed on them if they want to conduct business using mushārakah or mudārakah contracts. Such conditions are needed to ensure their accountability in order to assure their satisfactory performance.

**DAMĀN (GUARANTEE) CONCEPT IN MUDĀRABAH**

Although all respondents agreed that the damān concept is actually contrary to the concept of mudārakah (muqtaḍā al-‘aqrād), they still stress the need for a mechanism to make entrepreneurs serious in conducting the business.

**FEASIBILITY STUDIES**

All respondents disagreed with the proposal that failure to fulfil the expectations of a feasibility studies can be treated as evidence of negligence or misconduct. That is because the findings of feasibility studies are relatively subjective. Furthermore, it is normal in business for results to differ from projections due to unexpected factors. They suggested that the court is the proper party to determine negligence and misconduct.

**NO REASON TO STRENGTHEN MUDĀRABAH AND MUSHĀRAKAH PRODUCTS**

The most regrettable and painful result of the interviews is that the industry is quite reluctant to enhance their participation in mudārakah- and mushārakah-based products. It is due to a number of reasons such as the trustworthiness issue between the bank and its customers. This issue remains a major challenge for regulators in determining their policies regarding the application of both contracts.

**ACKNOWLEDGEMENT**

The article is part of the research report for the Research Grant of International Syariah Research Academy (ISRA research grant) in 2014.
REFERENCES


MPRA Paper 12732, University Library of Munich, Germany, revised Nov 1996.


http://www.islamweb.net/newlibrary/showalam.php?id=12526


Asmadi Mohamed Naim (corresponding author)
Islamic Business School (IBS)
Universiti Utara Malaysia
06010 UUM Sintok, Kedah, Malaysia.
E-Mail: asmadi@uum.edu.my

Mahyuddin Abu Bakar
Islamic Business School (IBS)
Universiti Utara Malaysia
06010 UUM Sintok, Kedah, Malaysia.
E-Mail: mahyuddin@uum.edu.my

Muhammad Nasri Md. Hussein
Islamic Business School (IBS)
Universiti Utara Malaysia
06010 UUM Sintok, Kedah, Malaysia.
E-Mail: mnasri@uum.edu.my

Mohamad Noor Habibi Long
Islamic Business School (IBS)
Universiti Utara Malaysia
06010 UUM Sintok, Kedah, Malaysia.
E-Mail: mnhabibi@uum.edu.my