

CIFE05, 06, 07: UNDERSTANDING MUDARABAH – ISLAMIC INVESTMENT PARTNERSHIPS

Where Islamic banks meet conventional private equity type investing. Here you learn Mudarabahs, the Islamic business partnership where one partner supplies capital for the business and the other provides management expertise. We explain the Mudarabah structure and contrast it with Musharakah and Wakalah, explaining how they differ in banking practice. How is an investment partnership different from an agency



contract? We discuss the relative merits of the Mudarabah and the Wakalah structure in different situations. We also describe the Mudarib's role, the duration of Mudarabahs and the forms of capital contribution by the investor and in some cases even the Mudarib. We discuss the Mudarabah's management and the rules for sharing profit and loss. We also look at some practical examples showing how Islamic banks use Mudarabahs.

A Mudarabah is a partnership between two or more parties usually to conduct business or trade. Typically, one of the parties supplies the capital for the business and the other provides the investment management expertise.

The financier or the Rabb al Maal provides all the investment capital for the business.

The investment manager or the Mudarib is entrusted with the Rabb al Maal's capital, invests it in a Shariah-compliant project and takes full management responsibility.

The Rabb al Maal and Mudarib share profit based on pre-agreed ratios.

Types of Mudarabah

With respect to the scope of business activity, Mudarabahs may be unrestricted or restricted.

Unrestricted Mudarabah

The Mudarib is free to invest capital in any Shariah-compliant project of his choice.

Restricted Mudarabah

The Mudarib's investment of capital is restricted to specific sectors and activities and/or geographical regions only. Here too, all investments must be Shariah-compliant.

Investment of Mudarabah Capital

1. More than one Rabb al Maal
2. Mudarib also contributes capital
3. Mudarib invests business capital in a different project

More than one Rabb al Maal

Multiple capital providers pool in their contributions to the same project and hire an investment manager as Mudarib.

Mudarib also contributes capital

The Mudarib is permitted to contribute capital to the Mudarabah provided that the Rabb al Maal/Arbaab al Maal approve.

Mudarib invests business capital in a different project

The Mudarib as business manager is responsible for investing and managing the Rabb al Maal's funds, however, the Shariah permits him to use the capital for parallel investments (i.e. receive capital for Mudarabah and invest in a different venture).

Differences Between Mudarabah and Musharakah

1. In a Mudarabah, the Mudarib is solely responsible for managing the business, whereas in a Musharakah all partners have the right to participate in the business.
2. The Rabb al Maal provides the business capital and only on condition that the Rabb al Maal agrees can the Mudarib contribute capital to the Mudarabah whereas in a Musharakah all partners must contribute capital.
3. Rabb al Maal bears any loss to the business provided it is not due to the Mudarib's negligence, however, in a Musharakah all partners bear loss pro-rata to their capital contributions.

4. Mudarabah costs that relate to tasks that pertain to the Mudarib's domain are not billed to the Mudarabah business; only running costs are whereas in a Musharakah, partners bear all costs as they are subtracted from revenue prior to profit distribution.
5. The Mudarib may only receive the amount of capital that he requires to invest in the business whereas in a Musharakah, when the business project concludes, the partners retain the right to receive Musharakah capital according to capital contribution ratios.

Similarity between Mudarabah and Musharakah

1. The Mudarib is permitted to surrender all or part of his profit to the Rabb al Maal provided it is not pre-agreed. Similarly in a Musharakah, a partner may give up his profit in favour of another on the strict condition that it is not predetermined.

Differences between Mudarabah and Wakalah

1. The Mudarib in a Mudarabah receives a share in profit whereas the Wakeel or agent in a Wakalah receives a fixed fee for services.
2. The Mudarib gets paid his profit share only if there is profit whereas the Wakeel receives a fee in any case.

Similarity between Mudarabah and Wakalah

1. Both Mudarabah and Wakalah are principal-agent contracts and profit is not guaranteed in either case.

Mudarabah Duration

Ongoing: Partnerships where there is no intention of concluding the business venture at any known point, however, partners have the option of exit provided they give prior notice to the other partners.

Temporary: Partnerships created with the specific intention of terminating them at a given future point in time. When the time is over, the Mudarabah assets are sold and distributed with any remaining profit on a pro-rata basis.

Mudarabah Capital

All Shariah-compliant items of material value may serve as Mudarabah capital. The capital may be cash or in kind. In case it is in kind it is important to ensure that the assets are valued at the time of Mudarabah's execution.

Partners' capital investment must be established at Mudarabah execution or at the latest before the business generates any profit. If partners are investing in different currencies it is important to agree upon one particular currency or numeraire to serve as a standard value for the business.

Debt cannot serve as Mudarabah capital.

Partners may agree on individual profit shares.

For the Arbaab al Maal, the ratios of capital contribution may help them in developing their profit sharing ratios but in practice these profit sharing ratios differ from capital contributions ratios.

Example:

A furniture business is set up between one Mudarib and one Rabb al Maal.

The Rabb al Maal contributes \$5,000 cash. There are no other assets at this point.

The annual profit sharing ratios are agreed at 60% for the Rabb al Maal and 40% for the Mudarib.

The profit in the first year is \$10,000 which is distributed as \$6,000 for the Rabb al Maal and \$4,000 for the Mudarib.

Mudarabah Management

Only the Mudarib possesses the right to manage the business.

The Rabb al Maal/Arbaab al Maal serve in the capacity of silent partners.

While restricted Mudarabahs are permitted, no conditions that may restrict or impede the Mudarib's management of business are allowed.

As business manager, the Mudarib receives a profit share for his effort however he is not entitled to a fixed remuneration for his services.

If the manager wants to receive a fixed wage he must be employed under a Wakalah contract as Wakeel, in which case he does not receive a profit share.

If the Mudarib is permitted by the Rabb al Maal/Arbaab al Maal to invest in the business, then by means of a separate contract he may make an investment contribution and become a Rabb al Maal. It is important to remember that his roles as Mudarib and Rabb al Maal are independent of one another.

Mudarabah Profit Sharing

The profit sharing mechanism and mutually agreed profit ratios must be clearly defined for all the partners at the Mudarabah's inception or before profit or loss is generated.

Profit amount cannot be guaranteed or fixed in absolute terms for any of the Mudarabah partners and neither can it be a percentage of capital.

A partner may voluntarily surrender all or part of his profit share to another partner provided it is not pre-agreed at contract execution.

Loss in a Mudarabah

The Rabb al Maal/Arbaab al Maal bear(s) the entire loss based on capital contribution ratios.

The Mudarib does not bear any loss except that caused by his proven negligence.

Mudarabah Termination

A Mudarabah may be terminated by any party at any time provided the terminating party gives prior notice however a 'lock-in' clause may be established for a certain period that the Mudarabah must remain in operation unless unexpected circumstances such as death or injury materialize.

At termination, business assets in the form of cash are distributed based on capital contribution for cash and profit sharing ratio for profit. If the business capital is in illiquid form, it is realized in cash. Next after calculating accrued profit, the cash and profit are distributed as per capital contribution and profit sharing ratios.

Mudarabah – Practical Applications at the Islamic Bank

Islamic banks collect money from their depositors on a Mudarabah (or Musharakah) basis and then form a Mudarabah (or Musharakah) pool.

The bank serves as Mudarib to manage the pool.

Based on its contractual agreement with its account holding customers, the bank retains the right to invest in the Mudarabah (or Musharakah) pool if it wants to.

The bank uses the capital to make a range of Shariah-compliant investments.

Operationally there is one difference, where normally profit in partnership based ventures like Mudarabah are shared after costs have been deducted from the revenue, since it is difficult for Islamic banks to identify and allocate costs to different pools and projects, they absorb the costs and instead share gross profit.

Mudarabah accounts are usually offered through savings or term deposit accounts where normally a longer duration of deposit corresponds to a higher expected profit rate.

Such accounts have 'expected' profit rates attached with them. These are the rates the account holders can expect to receive.

It is important to remember that the bank cannot guarantee its rates of return.