

# MUDARABAH

## **Mudarabah: Investment Financing**

*How does Mudarabah work as an Islamic mode of financing?*

A Mudarabah agreement creates a partnership business whereby an investing partner (rab al maal) brings capital and a working partner (mudarib) brings time and effort to share in profits according to a percentage agreed upon beforehand.

The investor has no direct involvement with the management of the business after the investment is made, though there are restricted Mudarabahs that specify the kind of venture intended, and unrestricted Mudarabahs that leave all discretionary powers in the hands of the worker to invest capital in the most productive manner possible.

The investor has the right to oversee business activities and, to the extent agreed upon by the mudarib, work directly with the mudarib. The worker has a fiduciary responsibility to the investor to maximize profits, within the parameters of the Shariah, because the investor is the one owning all the assets and bearing all the losses. There is no salary for the worker in a Mudarabah; he takes only that share of the profits to which he is entitled, while expenses relating to the business come from the business itself.

## **A Mudarib Is Entitled Only To Profit, Not Salary**

*May a mudarib earn a salary in addition to his share of profit?*

There is no salary for the worker in a Mudarabah; he takes only that share of the profits to which he is entitled.

## **Profit Shares Preset As Percentage Figure**

*How are the profit shares determined under a Mudarabah agreement?*

Profit shares must be known as a percentage, not as an absolute term, of earnings (ie. net income or profit) beforehand.

### **Prohibition Of Pooling Profits In Mudarabah**

*Is it permissible to pool the profits of working partners?*

It is forbidden to pool the profits of working partners, though it is acceptable for individual working partners to share their profits after distribution.

### **Liability For Losses In Mudarabah**

*In a Mudarabah agreement, who has the primary liability for loss?*

The investor bears all losses barring negligence, in which case the negligent party is financially liable.

### **Prohibition Of Spreading Losses By “Distributing” Negligence**

*Is it permissible to “distribute” negligence to spread loss?*

It is impermissible to “distribute” negligence by holding all the working partners liable for the mistakes of a few.

### **Responsibility Of The Working Partner**

*What is the responsibility of the working partner in a Mudarabah?*

The working partner accepts the investment capital of the Mudarabah in the capacity of a trustee. Unless the capital is lost due to his negligence, he is not liable to replace it. Once the business commences, the working partner as agent conducts all business activities. The working partner assumes the status of an employee if the Mudarabah is rendered invalid. In such a case he is remunerated for his services for the period he has worked based on the going market rate. The working partner may assume partnership in a Mudarabah by making a capital contribution. His status as co-investor is independent of his role as the working partner. In case he ceases to be a working partner he remains an investor and vice versa.

### **Mudarabah: Permissibility For Working Partners To Act On Behalf Of One Another**

*May working partners, engaged in a Mudarabah agreement, act on each other’s behalf?*

If working partners provide a service, they may act on behalf of one another as agreed upon (e.g. buying, selling, managing, etc.) and no partner may refuse participation in the provision of any agreed upon services.

### **The Extent Of Working Partner's Authority In Mudarabah**

*May a working partner, or a number of them, act on behalf of the Mudarabah, without authorization from the rest of the partners?*

It is impermissible for working partners to act on behalf of the Mudarabah or to use, buy or sell the property of the Mudarabah without the permission of all the other partners, unless the other partners have specified the manner and extent to which assigned partners may do so.

### **No Profits For Providing Intangible Benefits In Mudarabah**

*May an investor claim a share of the profit for having provided intangible benefits like guarantees?*

The investor must have invested some form of capital into the Mudarabah; it is forbidden to partake in profit in exchange for something other than capital, such as one's "guarantee," "connections," "reputation," and the like.

### **Immediate Cancellation Of Invalid Mudarabah**

*What should be done in case the Mudarabah is found to be invalid?*

If a Mudarabah is found to be invalid, it is cancelled immediately; the partners are then entitled to enter into a new agreement that is valid.

### **Loss, Damage, Or Theft Before Capital Distribution**

*In the event that a Mudarabah's capital is lost, damaged, or stolen before its distribution among the working partners by the investor, what happens to the Mudarabah partnership?*

The partnership is cancelled and, if so agreed, renewed.

### **The Form Of Capital Investment**

*In what form should capital investment be contributed for a Mudarabah?*

Capital investment may be contributed in cash or in kind.

### **Different Profit Ratios For Different Partners In Mudarabah**

*Can different profit ratios be agreed for different working partners in a Mudarabah?*

It is permissible to agree different ratios of profit for different working partners in a Mudarabah.

### **Fixing Different Profit Margins For Different Business Areas**

*Is it possible to vary profits margins by business area?*

Before finalizing an agreement in a restricted Mudarabah, the investor may stipulate that some areas of the business earn the worker higher profit margins than others, for instance, the mudarib's profit share is 20% in textile businesses and 30% in electronics businesses.

### **The Dos And Don'ts Of Profit And Loss Distribution**

*How is profit and loss distribution measured in a Mudarabah?*

It is central to the validity of the Mudarabah that distributions be measured as a percentage of profit and loss, not as a fixed amount, percentage of total capital, total revenue or some other absolute amount.

For wholly-owned Mudarababs, profits and losses are netted against one another, whereas for different businesses, as differentiable by the fact that they hold separate Mudarabah agreements, profits and losses are treated separately for separate businesses.

At any point during the agreement's tenure, either the investor or the worker can give notice and leave the Mudarabah. Of whatever remains of the business, non-liquid assets are liquidated and combined to yield a total value for the business. In order, the investor has first rights to his principal amount, the remainder of which is divided between the investor and mudarib(s) according to their respective shares.

If the business incurs only losses, and only a portion of the original principal remains, the amount goes entirely to the investor and the mudarib receives nothing.

## **Types Of Mudarabah**

*What are the different types of Mudarabah?*

There are two types of Mudarabah: restrictive and unrestrictive.

Restrictive Mudarabah means that the investor has specified investment details in the Mudarabah contract and has restricted the working partner within the scope of such specifications. Due care and precaution must be taken by the working partner to honor the restrictions imposed by the investor.

Unrestrictive Mudarabahs mean that the investor has granted the working partner the right to undertake any lawful investment. The working partner has the right to invest in any suitable investment that is reasonably expected to yield profits. It is the responsibility of the working partner to avoid unlawful and high-risk investments, and the working partner is liable for any losses suffered from such investments.

## **Stipulating Time In Mudarabah**

*Is it permissible to restrict the time-period of investment in a Mudarabah contract?*

It is permissible for the investor to restrict the time-period of investment in a Mudarabah contract. At the end of the specified time-period, all transactions cease and the profit or loss is divided as per Mudarabah contract.

## **Investor Receiving Percentage Of Each Investment From Working Partner**

*Is it permissible for the investor to demand from the working partner a certain percentage of each investment to be made, in addition to his share of proceeds of investment?*

It is not permissible for the investor to demand such money from the working partner. The role of the working partner is that of a trustee, and a trustee cannot be required to pay any amount to the investor except in case of the trustee's negligence.

### **Utilization Of Money Collected As Surety**

*Is it permissible for a bank to use the money collected as a surety for investments under a Mudarabah contract?*

It is permissible for a bank to use the money collected as a surety for investments under a Mudarabah contract.

### **Investor Acting As Working Partner**

*Is it permissible for an investor in a Mudarabah to also act as working partner?*

It is permissible for the investor in a Mudarabah to assume the role of working partner as well. This is particularly relevant in Mudarabah transactions involving multiple banks, where each bank is an investor and one bank is an investor and a working partner.

### **Appointment Of Agent By Working partner**

*Is it permissible for the working partner of funds in a Mudarabah to transfer the funds collected to an agent for investment?*

It is permissible for the working partner to appoint an agent for investing the money collected.

### **Expanding Mudarabah Investment Portfolio**

*Is it permitted for a bank to expand its Mudarabah investment portfolio without informing the investors?*

It is not permissible for the working partner (the bank, in this case) to expand its investment portfolio without consultation with the investors. The investors who agree to the expansion are treated as investors under an Unrestrictive Mudarabah, while the investors who do not agree to the expansion are treated as investors under a Restrictive Mudarabah and funds contributed by the latter are invested as before.

### **Reserve Fund Out Of Mudarabah Investors' Funds**

*Is it permissible for a bank to set aside a certain percentage of investors' money for the creation of a reserve fund as a remedy against investment risks?*

It is permissible to create a fund out of the investors' money in order to mitigate risks arising out of investments. The terms and conditions of the investors' contribution, including the percentage to be deducted, are mentioned in the Mudarabah contract.

The money so contributed by each investor is in the form of a gift, such that the investor will have no further claims on that money. The reserve fund is managed by the bank (working partner) and will be used either when the investors' money is at risk or when the return on investment is so low that it adversely affects the bank's reputation. It is the bank's responsibility, as working partner of the reserve fund, to invest the fund's resources in suitable and profitable ventures.

All yields from such investments are added to the reserve fund. The bank continues to operate the fund for as long as it remains in operation. In the event of the bank's winding up, the fund is dissolved and all proceeds are donated to charity.

### **Categorization Of Profit Rates In Mudarabah Investment**

*Is it permissible to categorize investors in a single Mudarabah, with different profit rates for each category?*

It is permissible to categorize investors in order to have different profit rates for each category of investors. The categories may be made on any just and sound basis, such as the period of investment or the amount of investment. However, it is necessary that the investor and the working partner both agree and understand the implications of such categorization, and that it is mentioned clearly in the Mudarabah contract.

### **Restriction On Investments By Investor In Mudarabah**

*Is it permissible for an investor to place restrictions on the working partner of Mudarabah regarding investments?*

The investor is entitled to impose restrictions on investments and the working partner will be obliged to comply with such restrictions.

### **Withdrawal By Investor In Mudarabah Before Due Date**

*Is it permissible for an investor to withdraw his contribution in a Mudarabah before the due date of distribution of profits? What right does he have to profits earned up to that date?*

It is permissible for an investor to withdraw his contribution before the due date of distribution of profits. The investor will be entitled to the profit earned on his investment up to the date of his withdrawal.

### **Forfeiture Of Profit Due To Withdrawal Before Maturity**

*Is it permissible to include a clause in a Mudarabah contract that would require the investor to forfeit all profit earned on his investment in case of early withdrawal?*

It is permissible to include such a clause in the Mudarabah contract, and in such a case, the investor will be obliged to forfeit all profit earned on his investment. The amount of profit forfeited will be credited to the Mudarabah Reserve Fund.

### **Expenses Of Mudarabah Operation**

*Who is responsible for expenses in a Mudarabah operation: the investors or the bank (working partner)?*

The bank will be responsible for such administrative expenses as are required for its general activities as a manager, but not for those expenses that are wholly unrelated to the bank's role as working partner.

### **Mudarabah Investment In Other Than Cash**

*Is it permissible for investors in a Mudarabah to contribute wealth other than in cash, such as goods or equipment?*

The majority of Islamic jurists are in agreement that Mudarabah investments may only be made in cash. Therefore, the investors in a Mudarabah should be called upon to make their full investment in cash.

## **Termination Of Mudarabah And Disposal Of Assets**

*In case of termination of a Mudarabah through the investor buying all the assets of the partnership, is it permissible for that investor to sell such assets under a Murabaha?*

In the case described above, the Mudarabah operation has ceased to exist and all assets belonging to the Mudarabah operation are now in the custody of the investor. It is permissible for the investor to dispose of the assets in any manner he deems suitable, including Murabaha. However, care must be taken to comply with all the requirements of a valid Murabaha sale, including disclosure of the exact purchase price of goods from the partnership, as well as any ancillary expenses.

## **Combining Multiple Mudarabah Operations**

*Is it permissible for a bank to combine all its Mudarabah operations and invest the money as a whole?*

It is permissible to combine multiple Mudarabah operations, provided that the yield from investment be distributed to all investors in accordance with the agreed upon proportions.

## **Zakat On Mudarabah**

*Is it permissible for the working partner to deduct zakat on Mudarabah operations on behalf of the investors?*

It is permissible for the working partner to deduct zakat from Mudarabah operations from the investors' accounts, provided that he has been authorized to do so by the investors.

## **Project Evaluation Charges Prior To Contract**

*In case a client approaches a bank to finance a particular project, is it permissible for the bank to charge a fee for evaluating the profitability of the project prior to entering into a financing arrangement?*

It is permissible for the bank to charge a fee for evaluation of the project, provided that such fee is charged before entering into a financing arrangement.

### **Multiple Working Partners In Mudarabah Contract**

*Is it permissible for the working partner in a Mudarabah contract to bring in another working partner?*

It is permissible for the working partner in a Mudarabah contract to appoint another working partner with the approval of the investors. However, the investors will not be liable to pay the second working partner. The proportion of yield payable to the working partner will remain same and will be shared by the two working partners.

### **Distribution Of Profits Prior To Allocation Of Expenses**

*Is it permissible to distribute profits from a Mudarabah contract before expenses have been allocated and netted off from the profits?*

It is not permissible to distribute profits before the allocation and net-off of expenses. The amount that remains subsequently will be termed net profit and will be distributed among the investors.

### **Deduction Of Salary Expense From Mudarabah In Two Stages**

*Is it permissible to deduct salaries from the Mudarabah in two steps: the first deduction being along with other administrative expenses, while the second being the salary of the bank's shareholders out of the net profits?*

It is permissible in the Shariah to deduct salaries from the Mudarabah in the mode described. The second deduction represents nothing more than the bank's share in the profits of the Mudarabah operation, in its capacity as working partner, and such profit is to be paid to the bank's shareholders. Care should be taken to ensure that the second deduction is according to the share of the bank as prescribed in the Mudarabah contract.

### **Division Of Investment Yield Not Commensurate With Capital Investment**

*Is it permitted for the investors to mutually agree upon a formula of division of investment yield that is not commensurate with the capital invested?*

This returns to whether there is profit or loss on the investment. In case of profit, it is permissible to divide it according to any mutually agreed ratio. The investors are not bound to divide profits in proportion to their capital investment. This entails, for example, that two investors may have a 1:1 ratio of capital investment, and 2:3 ratio of division of profits. However, loss on investment may only

be divided in proportion to capital invested. Losses are charged directly to the capital itself, therefore their division must be according to the proportion of capital invested by each investor. Any stipulation that states to the contrary will be considered void.

### **Working Partner's Share In Loss On Investment**

*In case there is loss on investment, is it permissible to make the working partner liable to bear a percentage of that loss?*

The working partner may not be held financially responsible for any loss on investment unless it can be proved that he acted with negligence or incompetence. This is because the working partner has not invested any capital and will not be required to bear any negative consequences. If the Mudarabah contract stipulates that the working partner will be financially responsible for loss, such a condition will be void, though the Mudarabah contract itself will remain valid.

### **Early Distribution Of Profits**

*Is it permissible for the investors in a Mudarabah contract to decide to distribute profits before the conclusion of the Mudarabah contract?*

It is permissible for investors to mutually decide to distribute profits before the conclusion of the Mudarabah contract.

### **Alteration Of Mudarabah Contract**

*Is it permissible to alter the Mudarabah contract in order to change the profit percentages or any other clause?*

It is permissible to alter the Mudarabah contract if all the parties agree to the change. The alteration may pertain to profit percentages or any other clause.

### **Fixed Payment To Investor**

*Is it permissible to include a clause in the Mudarabah contract that entitles the investor to receive a periodical fixed payment in addition to the profit distribution, regardless of whether the investment profits or loses?*

It is not permissible for the investor to demand such a fixed payment in addition to his entitlement to profit. This would entail making the working partner financially liable, which is impermissible.

### **Promising Additional Profits To Working Partner**

*Is it permissible for the investors to promise additional profits to the working partner as a form of motivation?*

It is permissible for the investors to reach such an agreement with the working partner, provided that the division of profits is according to the Mudarabah contract.

### **Profit Distribution In Long-Term Mudarabah Contracts**

*In case of long-term Mudarabah contracts, is it permissible to periodically distribute profits among investors instead of a bulk distribution at the conclusion of the Mudarabah contract?*

It is permissible, with mutual agreement among investors, to periodically distribute profits instead of a bulk distribution at the conclusion of the contract.

### **Converting Mudarabah Into Musharakah**

*Is it permissible for the parties to a Mudarabah contract to convert it into a Musharakah, and subsequently attract more capital through the issue of Shariah-compliant financings?*

It is permissible to convert a Mudarabah into a Musharakah and to raise capital through financings. It should be noted, however, that before entering into a contract, all parties should agree on definite objectives of their Mudarabah partnership in order to avoid any future ambiguities.

### **Termination Of Mudarabah**

*How is a Mudarabah terminated?*

In a Mudarabah any of the partners may leave the business at any time. If a time limit is agreed upon, then such an agreement must be strictly adhered to by both parties. At the time of termination, the business is liquidated, whether through the sale of assets or through their constructive liquidation. All expenses directly related to the Mudarabah operation are paid for from its earnings. All other expenses ensuing from the running of the business as is the market norm, are the working partner's responsibility.

## **Mudarabah Costs**

*What costs are categorized as the Mudarabah's running business costs and what costs is the Mudarib personally liable for?*

An example of costs strictly related to running a business include direct costs like raw material and direct labor while an example of indirect costs not billable by the Mudarib to the Mudarabah include the Mudarib's rent and utilities expenses, though the Mudarib and Rabb al Maal may agree a higher profit share for the Mudarib to offset these indirect costs.

## **Profit Distribution Ratios In Musharakah And Mudarabah**

*Why does the ratio of profit distribution differ in Musharakah and Mudarabah contracts?*

Profit distribution in a Musharakah is between partners who are both providing investment capital, while in a typical Mudarabah one party provides the capital and the other party only provides the work.