

"Mudarabah" Trading Models: Global Perspectives and Applications in Islamic Banking

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Abstract

Adopting various Islamic financing methods has undeniably enabled Islamic banks to demonstrate to people how to eliminate interest, marking a significant achievement. Nevertheless, it is essential for Islamic banks to also focus on partnership-based financing models like 'Shirkah' and 'Modaraba'. A close analysis of Shariah's objectives highlights a major shortcoming in Islamic banks: they have yet to invest in or attempt to invest through 'Shirkah' and 'Modaraba'. The term 'Islamic banking' encompasses not only transitional financing methods but also ideal ones. This article delves into the potential and practical investment methods based on 'Modaraba'. There are existing financing modes that resemble the Islamic model 'Modaraba', such as 'Venture Capital', 'Merchant Banking', and 'Holding Company'. With modifications in line with Shariah, these models could be adapted for partnership-based financing, thereby fulfilling Shariah's objectives. Should Islamic banks embrace these modes, they could see substantial growth in their sector.

Keywords: Interest-Free Banking, Islamic Finance Principles, Profit and Loss Sharing, Shariah Compliance, Ethical Investment, Islamic Economic System, Risk Sharing, Financial Innovation

"Mudarabah" trading models have become a cornerstone of Islamic banking, offering a unique and ethical approach to financial transactions. Rooted in Islamic jurisprudence, Mudarabah emphasizes profit and loss sharing, distinguishing it from conventional banking systems that rely on fixed interest rates. This model aligns with the principles of Shariah,

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which prohibit riba (interest) and promote risk-sharing between the capital provider and the entrepreneur.

Globally, Mudarabah has been implemented in various forms, adapting to different economic environments and regulatory frameworks. Its application ranges from small-scale investments to large-scale financing projects, reflecting its versatility and resilience. The global perspectives on Mudarabah highlight both its potential and the challenges faced in harmonizing traditional Islamic principles with modern financial practices.

Historically, Mudarabah has its roots in the early Islamic era, where it was used as a means of financing trade and commerce. Merchants and traders relied on this model to fund their business ventures, establishing a foundation of trust and mutual benefit. Over time, Mudarabah has evolved to meet the needs of contemporary Islamic banking, integrating advanced financial instruments and technologies.

Despite its numerous advantages, Mudarabah faces several challenges. These include regulatory inconsistencies, varying interpretations of Shariah compliance, and the need for robust risk management frameworks. Additionally, the integration of Mudarabah into global financial markets requires continuous innovation and collaboration among Islamic finance institutions.

This introduction aims to explore the theoretical foundations of Mudarabah, its practical implementations across different regions, and its significance in promoting ethical banking practices. By examining case studies and comparative analyses, we can gain a deeper understanding of how Mudarabah trading models contribute to the development of a more equitable and sustainable financial system. Furthermore, we will discuss the potential for Mudarabah to address modern financial challenges and its role in the future of Islamic banking.

Since the following discussion primarily concerns investment based on Mudarabah, we first present the definitions of Mudarabah.

According to the *Hanafi* jurists:

"هِيَ شَرَكَةٌ بِمَالٍ مِنْ جَانِبٍ وَعَمَلٍ مِنْ جَانِبٍ"¹

"It is a partnership where one party provides the capital, and the other provides the labor."

According to the *Hanbali* jurists:

Allāma Ibn Qudāma has defined and explained Mudarabah as follows:

"أَنْ يَشْتَرِكَ بَدَنٌ وَ مَالٌ وَهَذِهِ الْمُضَارَبَةُ ، وَتُسَمَّى قَرَضاً أَيْضاً ، وَمَعْنَاهَا أَنْ يَدْفَعَ رَجُلٌ مَالَهُ إِلَى آخَرَ يَتَجَرُّ لَهُ فِيهِ ، عَلَى أَنْ مَا حَصَلَ مِنْ

الرَّيْحِ بَيْنَهُمَا حَسَبَ مَا يَشْتَرِطَانِهِ فَأَهْلُ الْعِرَاقِ يُسَمُّونَهُ مُضَارَبَةً"²

"It is when a body and capital are combined, and this is called Mudarabah, which is also known as *Qirāḍ*. Its meaning is that one person gives his capital to another to trade with, under the condition that the profit obtained will be shared between them according to the agreed-upon terms. In Iraq, this is referred to as Mudarabah."

Allāma Jazā'iri has provided the same definition, with the additional point that the responsibility for any loss lies with the owner of the capital.³

Allāma Ibn Qudāma has also narrated a consensus on the permissibility of Mudarabah, stating:

"The scholars unanimously agree on the permissibility of *Mudarabah* in general."⁴

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State Bank of Pakistan's Definition of Mudaraba:

Mudaraba is a financial arrangement where one individual provides capital (known as *Rabb-ul-Māl*) and another contributes their expertise and effort (known as *Mudārib*). The profits generated from investing these funds are shared between the two parties according to a pre-agreed formula.⁵

Definition of Mudaraba in *Al-Ma'āyir Al-Shar'iyah*:

Mudaraba is a partnership in profit with capital from one side (*Rabb-ul-Māl*) and labor from the other side (*Mudārib*).⁶

Definition of Venture Capital:

Capital supplied by investors to emerging startups and small enterprises that exhibit potential for substantial long-term growth..⁷

Venture Capital Explained

Venture capital refers to the funds invested by investors in startup companies and small businesses that demonstrate potential for long-term growth. This form of financing is vital for early-stage companies that lack access to capital markets. Although the risk for investors is considerable, the potential for high returns is equally substantial. In addition to financial support, venture capital often brings administrative and technical expertise to the companies they invest in.

A large share of venture capital originates from affluent individuals, investment banks, and financial institutions that participate in these investments or partnerships. This funding approach is especially favored by startups or ventures with a brief operational history and those that cannot secure funds through issuing debt securities. Generally, these investors hold decision-making power in the company corresponding to their equity stake..⁸

Venture capitalists are professional investors specializing in financing and nurturing startups with promising futures. They make long-term investments and work closely with the companies they invest in. Unlike other investors, venture capitalists are prepared for long-term investments and generally do not expect returns for an average of seven to ten years. They play an active role in their portfolio companies, providing both capital and expertise, which is highly valuable. They often contribute to building strong management teams, facilitating rapid growth, and providing infrastructure for partnership.

The majority of venture capital firms secure funding from institutional investors like pension funds, insurance companies, endowments, foundations, and affluent individuals. Investors in venture capital funds are referred to as Limited Partners, whereas the venture capitalists who manage these funds are known as General Partners and are fully accountable to their limited partners.

In 2009, there were approximately 794 venture capital firms in the United States managing around \$179 billion in capital, with an average venture capital fund size of \$151 million. That year, venture capitalists invested approximately \$18 billion in about 2,400 companies, creating millions of jobs.

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Venture Capital Organization (VCO)

Under this method, a group of Islamic banks would establish a venture capital fund to invest in distressed companies or acquire public companies facing privatization. Banking regulations may hinder the spread of capital from Islamic banks to such companies, which can be addressed by Islamic banks investing alongside management and institutional investors to a certain extent. Furthermore, the financing methods employed will not be interest-based but will adhere to Islamic investment principles.

Due to the establishment of a Venture Capital Organization (VCO), there will be a balance of power between management and financially contributing owners within the company. Shareholders will not be passive investors but will have the authority to make decisions alongside management. Managers who have a stake in the VCO are likely to be more beneficial because they may possess personal insights and experience in such ventures. When managers and shareholders are partners, both parties' focus will increase, and the agency problem will be mitigated.

In this manner, strategic controls will take precedence over financial controls within the VCO, as all shareholders—including managers, Islamic banks, and institutional investors—will participate in the company's administration and key decisions. These controls will promote long-term investments in diverse projects, enhancing the company's reputation. The cost-effective exchange of information within the VCO will streamline decision-making. Additionally, the involvement of institutional investors will create a robust oversight system, closely monitoring management actions and thereby reducing agency costs.

1. Initially, venture capital financing is highly risky. Even in the United States, where it is considered highly successful, the failure rate among the companies selected for investment is high. To mitigate this risk, venture capitalists, considering their managerial capabilities, generally invest in 20 to 30 companies.

2. The framework proposed for this purpose can be transitional. Until the governments of Muslim countries become serious about this, administrative changes in the banking sector are not possible.

In universal banking, Islamic banks can invest in public corporations, which will enhance the information and monitoring system, address various complaints, and yield diverse benefits. However, not all investments by Islamic banks will be through VCOs (Venture Capital Organizations). Islamic banks can establish a joint or individual monitoring agency that provides information on other companies, including those in which Islamic banks hold a stake.

In an ideal world where partners are sincere with each other, administrative and monitoring issues would be irrelevant. However, since this is not the case in reality, the issues raised are significant. Ignoring the above discussion, Islamic banks will continue to focus on methods that are both easy and free from risk, avoiding profit and loss sharing. However, if the aforementioned approach is adopted, either as is or with modifications, the risk of the collapse of the Islamic banking system will be mitigated.⁹

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Venture Capital Investment:

1. Fields of Venture Investment:

Venture capitalists play a crucial role in industries primed for expansion, including computers, biotechnology, and communication sectors. Currently, many venture capitalists have directed their investments towards high-tech companies in areas such as software, biotechnology, medical devices, media and entertainment, wireless communications, the internet, and networking. Recently, they have also ventured into environmental, energy, and power management sectors. Moreover, venture capital investments span consumer products, manufacturing, financial services, health services, and business products and services.

2. Economic Impact

Venture capital activity positively impacts the economy at both national and global levels. It creates jobs, fosters innovation, advances technology, increases tax revenues, and enhances international competitiveness. Venture capitalists invest in high-risk areas but manage this risk through portfolio management. Approximately 40% of the companies invested in through venture capital fail, 40% provide moderate returns, while only about 20% or fewer yield substantial profits. This small percentage of highly profitable investments distinguishes the venture capital industry in terms of returns compared to the general public market.¹⁰

Venture Capital Based on *Sharikat-ul-'Inān*:

From an Islamic perspective, venture capital is based on equity financing known as *Sharikat-ul-'Inān*. Thus, it can be carried out within the framework of Islamic investment principles. This makes it economically viable and preferable from an Islamic standpoint, making it attractive to Islamic investment institutions. Although not all current venture capital operations align with Islamic laws, these details can be modified without compromising its positive principles. Many researchers and the World Bank have praised and emphasized the venture capital methodology, providing guidance in this regard.¹¹

Benefits of Venture Capital

From the perspective of an entrepreneur, many talented businesspeople struggle to sustain their ventures due to insufficient resources. Traditional sources like banks are often unwilling to invest in their businesses because of the high risk involved. Thus, for these entrepreneurs, venture capital becomes the only viable option. They can secure this either through conventional venture capital funds or as external investments through non-traditional means. If the entrepreneur wants to mitigate risk, they might prefer to partner with a venture capitalist, as equity financing involves sharing asset losses. This makes many talented entrepreneurs willing to involve venture capitalists in their businesses.

Many promising businesses possess the ability to innovate and create but lack the necessary experience in management, marketing, and financial planning. This is another reason why many entrepreneurs accept the venture capital method to compensate for this lack of experience. Additionally, there is the issue of reputation, which can be gained through venture capital. This reputation helps businesses obtain future capital at lower costs. For example,

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venture-backed initial public offerings (IPOs) are generally more successful than those without venture backing, leading banks to prioritize companies with venture support. The staged investment process also encourages capable entrepreneurs to enter the venture capital field while deterring less competent ones. Good entrepreneurs will understand that if they perform well, the capital they receive in subsequent stages will come on better terms and with more favorable conditions.¹²

Performance of Venture-backed Companies

Mull (1990) compared 340 venture-backed companies with 340 non-venture-backed companies that went public between 1983 and 1987. The study found that the earnings per share of venture-backed companies showed significantly higher gains compared to their non-venture-backed counterparts. This indicates that while venture-backed companies are generally riskier, their income growth rate is also higher. Similarly, *Al-Suwailem* (1995) compared 236 small high-tech companies with venture backing against 138 companies of the same size and sector without venture backing. The overall results favored venture-backed companies, highlighting various benefits.

Islamic banks typically limit their investments to well-established businesses and corporations, neglecting small and startup businesses that face capital shortages. This is contrary to the natural business model of Islamic finance, which encourages profit and loss sharing and investment in early-stage businesses. The current business model of Islamic banks resembles that of traditional banks, focusing on short-term investment needs of the real economy and providing interest-based methods and facilities. Limiting themselves to this approach is insufficient for Islamic banks, whose purpose is to meet real investment needs through profit and loss sharing methods. Competing with traditional banks, which are much larger and more agile in fulfilling such economic needs, would be challenging for Islamic banks if they adhere strictly to this limited approach.

Islamic banks must provide both commercial and investment banking services. The Governor of the State Bank suggested engaging in Salam financing with farmers through NGOs and microfinance institutions. Additionally, Islamic banks can participate in *Istisna* (استصناع) contracts with federal and provincial governments for projects like buildings and low-cost housing.

It is important to note that profits in *Istisna* are several times higher compared to Murabaha and Salam. This presents a significant opportunity for Islamic banks to diversify and increase their profit margins.

Definition of Holding Companies:

A holding company is a parent corporation that owns enough voting stock in another corporation to control its policies and management. This type of company exists primarily to own shares of other companies to form a corporate group. Unlike other types of businesses, holding companies do not produce goods or services themselves; instead, their main purpose is to manage and oversee other companies, known as subsidiaries, which can include managing assets, overseeing operations, and consolidating financials.¹³

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Explanation

1. **Control and Management:** Holding companies exercise control over their subsidiaries by owning a majority of their stock. This ownership allows the holding company to influence or direct the subsidiary's policies and management decisions.¹⁴
2. **Legal and Operational Structure:** Holding companies can centralize the management of various businesses under a single corporate umbrella, which can lead to more efficient operations, risk management, and resource allocation. They provide a structure where each subsidiary operates independently but under the strategic oversight of the holding company.¹⁵
3. **Benefits:** One significant advantage of a holding company is the ability to reduce risk by spreading investments across various industries or sectors. It also allows for better tax management and financial stability. For example, if one subsidiary faces financial difficulties, the holding company and other subsidiaries may not be directly affected.¹⁶
4. **Asset Protection:** Holding companies can protect their assets by separating them into different subsidiaries. This way, if one subsidiary encounters legal issues or financial troubles, the assets of the other subsidiaries and the holding company itself can be shielded from direct impact.
5. **Strategic Flexibility:** By owning multiple subsidiaries, a holding company can quickly adapt to market changes by reallocating resources, divesting underperforming units, or acquiring new businesses that align with its strategic goals.

Merchant Banking: Definitions and Functions

A merchant bank is a financial institution that supplies capital to companies through equity ownership rather than providing loans. It also offers financial advice and strategic guidance to corporate clients, often collaborating with firms that extend loan services.¹⁷

In the realm of banking, a merchant bank primarily offers financial services and advisory to corporations and wealthy individuals. This term is also used to describe private equity activities within banking.¹⁸

The primary difference between a merchant bank and an investment bank lies in their investment strategies. A merchant bank invests its own capital directly into client companies, while an investment bank primarily engages in underwriting and trading securities issued by those companies. Both types of banks also offer corporate advisory services for a fee.

Often, merchant banks are involved in international investments, providing long-term loans, and underwriting services for companies. Unlike traditional banks, merchant banks do not offer standard banking services to the general public. Many investment banks, on the other hand, engage in commercial investment activities.

This translation highlights the key roles, differences, and services offered by merchant banks in comparison to investment banks, emphasizing their unique approach to corporate finance and investment.

The History of Merchant Banking

Historically, the primary purpose of a merchant bank was to facilitate the production and trade of goods by providing necessary capital. Today, some banks still limit their activities to

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this fundamental role. Merchant banks are, in essence, the original banks. They were established during the medieval period by Italian grain merchants.¹⁹ Many Jewish merchants, who fled the persecutions in Spain, also took an interest in trade and brought ancient methods from the Middle East and the Far East.²⁰ They primarily invested in long trading voyages, using these methods to finance the production and trade of grain.

In Italy, Jews were unable to own land, so they integrated into the large trading markets alongside local merchants and established their bases for grain trading.²¹ They had a significant advantage over the locals as Christians were strictly prohibited from lending money at interest, a prohibition similarly observed in Islam. Consequently, Jewish merchants lent money to farmers at interest in exchange for the grain produced on their fields, a high-risk loan that was prohibited by the Church, but the Jews were not bound by the Church's edicts.²² In this way, they secured the rights to sell the future harvests. They also made advance payments for grain arriving from distant ports, ensuring their future profit due to the lower present cost.

This bilateral trade was time-consuming, and soon a class of traders emerged who traded in grain debt rather than grain itself. In Islam, farmers are provided this facility in the form of *Muslam* without economic exploitation.

Jewish merchants were involved in both financing (loans) and underwriting (insurance). Financing meant providing loans at the beginning of the season so a farmer could arrange for seeds, cultivation, and harvesting. Underwriting involved ensuring the delivery of goods to the buyer, who was usually a large trader and wholesaler. They made alternative arrangements in case of non-availability of grain. For instance, if a famine prevented grain from being grown, they helped the farmer through grain insurance. These institutions gradually evolved into their present form. This intermediary also started performing these tasks for others, allowing people to invest their funds in grain trade through this middleman. The investors were issued receipts in exchange for their capital, which were notes written by those who had to provide the grain to this intermediary.²³

These deposited funds were primarily intended for purchasing grain from traders, but often, the merchants used these funds for their own commercial purposes. The term "bankrupt" comes from the Italian term "*banca rotta*" or "broken bench," used when someone lost the merchants' funds they were holding.²⁴

These individuals also devalued funds. During the Middle Ages (6th to 15th centuries), Italian markets were affected by wars, and the next generation of bankers emerged from migrating Jewish merchants who resided in highly productive grain regions like Germany and Poland. Many of these traders belonged to the same families that had been part of the banking development in Italy.²⁵

Large trading companies with permanent branches in many locations found it easier to transfer funds for other traders, leading to the emergence of merchant banks. These banks received funds in one place and paid them out in another, lending these funds further or investing them in trade during the interim. These banks had little of their own money; they primarily borrowed from others to lend further. Merchant banks trade various commodities and lend money. The funds for merchant banking come from two sources: their own capital and funds borrowed from others. Merchant banking firms typically operate on a partnership basis. Merchant banking is a highly profitable and risky method for a few bank holding

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companies and banks that have entered this field under existing laws.

Summary of Discussion:

1. Emphasizing that Islamic banks should only adopt investment methods that are simple, risk-free, and not based on profit and loss sharing is not the correct approach.
2. Islamic banks can earn profits through venture investments in various fields, and operating on the basis of venture capital will also have very positive effects on the economy. Just as venture capital is economically viable, it is also preferable from an Islamic perspective.
3. Islamic banks can also function as holding companies, managing subsidiary companies and earning profits from them.
4. Since the primary purpose of merchant banking is to facilitate the production and trade of goods by providing necessary capital, Islamic banks can also engage in merchant banking. A highly effective method of investment based on this principle is Muslam.
5. The State Bank of Pakistan should allow Islamic banks a certain extent of trading to enable them to participate in commercial activities while ensuring they do not establish a monopoly in the market. The profits of Islamic banks can also be capped to a certain limit.
6. The practical objections raised against adopting Musharakah and Mudarabah financing as a financing method are not insurmountable. Therefore, it is essential to promote Musharakah and Mudarabah-based financing in Islamic banks by implementing the solutions proposed by scholars and various experts.

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