

## **ANALYSIS OF THE ROLE OF MUDHARABAH PRINCIPLE IN DEVELOPING ISLAMIC FINANCIAL INSTRUMENT**

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### **Abstract**

Most Islamic financial institutions offered a variety of financial products and services that utilised mudharabah principle which based on profit and loss sharing concept. Mudharabah principle is a permissible commercial contract in Islam and it contributes many advantages for socio economic. However, in contemporary Islamic banking industry, Mudharabah principle is mostly used to finance short term commercial purposes rather than long term venture to yield in socio economic benefits for Ummah. Thus, the paper aims to observe the application of mudharabah principle in the Islamic banking products and to find the shariah issues that emerge in the Islamic finance products related to the application of mudharabah principle. The paper presents observation and document review from secondary data in the role of mudharabah to develop Islamic financial instrument. The paper finds the differences between mudharabah principle theoretical and practical that applied in the current bank industry and the weakness of mudharabah contract in Islamic bank. In terms of contributing the optimalization of application through mudharabah principle by exploring the issues that appear to the Islamic financial products.

**Keywords:** *Mudharabah*, Islamic Banking, Islamic Financial Instrument.

### **Abstrak**

Sebagian besar lembaga keuangan Islam menawarkan berbagai produk dan layanan keuangan yang menggunakan prinsip mudharabah yang didasarkan pada konsep pembagian laba dan rugi. Prinsip mudharabah adalah kontrak komersial yang diperbolehkan dalam Islam dan memberikan banyak keuntungan bagi sosial ekonomi. Namun, dalam industri perbankan Islam kontemporer, prinsip mudharabah lebih banyak digunakan untuk membiayai tujuan komersial jangka pendek daripada usaha jangka panjang untuk menghasilkan manfaat sosial ekonomi bagi umat. Dengan demikian, makalah ini bertujuan untuk mengamati penerapan prinsip mudharabah dalam produk perbankan syariah dan untuk menemukan masalah syariah yang muncul dalam produk keuangan Islam terkait dengan penerapan prinsip mudharabah. Makalah ini menyajikan pengamatan dan review dokumen dari data sekunder dalam peran mudharabah untuk mengembangkan instrumen keuangan Islam. Makalah ini menemukan perbedaan antara prinsip mudharabah teoretis dan praktis yang diterapkan dalam industri bank saat ini dan kelemahan kontrak mudharabah di bank syariah. Dalam hal berkontribusi optimalisasi aplikasi melalui prinsip mudharabah dengan mengeksplorasi isu-isu yang muncul pada produk keuangan syariah.

**Kata Kunci:** *Mudharabah*, Bank Islam, Instrumen Keuangan Islam.

## **I. INTRODUCTION**

Islamic finance is Islamic concept of socio-economic development of the muslim community. In this sense, the function of Islamic finance is not only to render financial instruments that are permitted under Islam, but also to take over social responsibility and to participate directly in the process of economic growth and development.

Islamic economic theorists and the *fuqaha* argued that the investment operations of Islamic banks would have to be based on profit loss sharing (PLS), such as *mudarabah*. These theorists said that the Islamic bank would provide its financial resources to the borrowers on a risk-sharing basis for long term infrastructural and industrial ventures for the benefit of the Ummah, unlike in the interests based financial system in which the borrower assumes all risks and where the lending decision is based on the issue of creditworthiness solely.

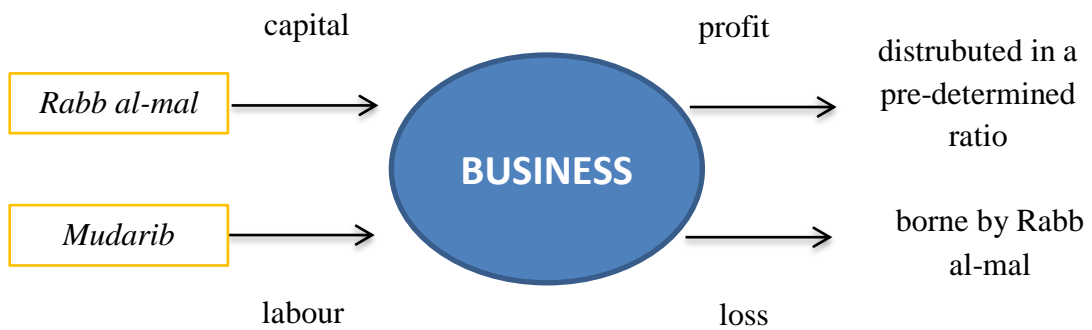
Two important issues will be dealt with regarding this financial instrument. First, there is a huge divergence between the *Shariah* verdicts of the *Fuqaha* and the contemporary finance practices in Islamic banks. Second, the conditions imposed by the *Fuqaha* on finance on a PLS-basis have been mostly too idealistic and probably were not considered thoroughly enough. PLS-instruments have been utilized on a small scale so far and it would be difficult to attractiveness of this financial instruments without easing certain restrictions or at least reconsidering relevant issues from a rational and realistic point of view.

## **II. LITERATURE REVIEW**

Hussain G Rammal on his paper agreed that *mudarabah* is an agreement between two parties, where one provides finance to another for utilization in an agreed manner (Rammal, 2005). The finances for the ventures are the responsibility of one party known as the Rabb-ul-mal (financier), whereas the management and execution of the project is the sole responsibility of the other party known as the *Mudarib* (entrepreneur). In addition, the economist states that the advantage of *Mudaraba* is that emphasizes the sharing of responsibility by the users of the money and thus helps make the free market system more than open and democratic.

Islamic banks have introduced the concept of *Mudaraba* in home financing and investment accounts. In home financing, the bank provides the capital for the purchases of the property and the borrower makes repayment based on the rental value of the property. Then in investment accounts, the profit sharing ratio and the maturity period vary from bank to bank, depending on supply and demand condition. Theoretically, the rate of return on these investment accounts could be positive or negative, but in reality the returns have mostly been positive and quite comparable to rates that conventional banks offer on their term deposits.

In addition, Shinsuke Nagaoka wrote that *mudarabah* contract is a form of contract in which one party provides capital with which another party undertakes some business (Nagaoka, 2010). Any profit from the venture is distributed between the parties in a ratio agreed before hand, while any loss entirely borne by rabb-ul-mal unless mudarib has a defect.



Experience through the growth of Islamic finance in the 1970s showed that, in practice, partnership based instruments are not necessarily suitable for most aspects of Islamic finance, particularly its asset side. The Middle East and Malaysia did not adopt partnership based instruments as core financial product, preferring mostly *mudharabah* contract, which are not partnership based.

The essential feature of profit loss sharing contract is that contracted parties share in the outcome of the venture. In terms of economics, any risk involved in partnership based instruments is shared by the contracted parties. As many Islamic economists and practitioners working at *Shariah* divisions of Islamic banks emphasizes, this sort of risk sharing is said to be highly consistent with one of fundamental notions of Islamic teachings. Therefore, risk sharing has been considered as the economic wisdom of partnership contracts in existing literatures by thinking back to the partnership contracts in pre modern times and clarifying the substantial wisdom in them. Thus, it will help to improve partnership based instruments in present Islamic financial practice.

The classical partnership contracts, which did not sufficiently develop the concept of corporate entity, have a discriminative economic features that restrains risk scattering. This reformulated economic wisdom derived from partnership contract can be called as risk sharing without risk scattering.

On the other hand, in Erna Rachmawati and Ekki Syamsulhakim's article found the using counteraction test indicates that the number of Islamic bank's branch offices and profit sharing rate are significantly affects the volume of *mudharaba* deposits in Indonesia in the long run, while GDP and interest rate are not (Rachmawati & Syamsulhakim, 2004). Nevertheless, the increasing number of Islamic commercial banks and Islamic banking unit in Indonesia has consequently been followed by an increase in the nominal volume of both *mudharaba* saving deposit and *mudharaba* investment deposit in the banks. Thus, the volume of *mudharaba* deposits in Indonesia does not depend on income or interest rate, but depend on profit sharing rate and the number of branch offices of the Islamic commercial banks. This finding supported the view that depositors are attracted to put their money in Indonesian Islamic banks partly due to welfare maximization reasons and accessibility of the Islamic commercial banks, not only because of their religious considerations.

The volume of fund that depositors entrust in banks plays an important role as a source of funds to be utilized by investors. In Islamic banks, there are several types of deposits that a depositor can obtain, but the types are not identical

in different countries. But in Indonesia, there are three types of deposits fund that are offered: *wadiah* currency account, *mudharaba* saving account, and *mudharaba* investment account.

The authors use an adaptive expectation model to investigate factors that affects *mudharaba* deposits in Indonesia, but slightly modifies the model by adding one more variable, which is the number of branch offices of Islamic commercial bank in Indonesia.

On the contrary, Mansor Jusoh and Norlin Khalid present the analyzing of demand for goods to be purchased by deferred payment. Thus, the demand will then be used to derive the demand for Islamic debt and they also investigate theoretically, factors that may have an impact on the demand for Islamic debt (Jusoh & Khalid, 2013).

There are two main types of contracts that define financing operation of the Islamic banking: the contract of PLS (*ukud al-isytirak*) and the contract of exchange (*ukud al-mu'awadhat*). Under the PLS contract bank provides *mudharabah* financing to its client for a share of profits (or losses), or *musyarakah* financing when the bank also becomes a partner in any venture or project. The contract of exchange requires bank to use its fund to facilitate economic transaction, usually involving a purchase of goods or assets from a third party and resell them its client on a different basis. In addition, *mudharabah* based models help facilitate understanding of the working of significantly to Islamic finance. However, the facts that *mudharabah* financing through PLS principle is the most sparingly used tools of financing in Islamic banking and it is on a declining trend.

The writers use the model which modified a classical model to be consistent with the principles of Islam that prohibit interest rate. In terms of analysis, they use micro foundation for macroeconomic analysis that links various sectors of an economy together. In addition, under the classical economy, wages and rental rate of capital are predetermined for firms. This implies the claim on capital and labor must be satisfied before knowing the actual profits of the firms. In contrast, under the Islamic economy, only wage for labor is predetermined while the capital is only rewarded if firm yields an economic profit. Both the entrepreneur and external financier will decide their agree profit sharing ratios before starting the business under *mudharabah* system.

Islamic financing techniques may have different effects on decision making of economic agents as well as on the macroeconomic framework of the economy. Although there have been a substantial amount of research studying the Islamic financing, most of the existing literatures only focus on a profit loss sharing system which based on *mudharabah* and *musyarakah* system. The practice in reality however, is over overwhelmingly dependent on the use of Islamic debt-based financing instrument while profit loss sharing is the least demanded as model of financing in most of the Islamic banks in the world.

Moreover, Muhammad Anwar begins with a distinction between *riba* (usury) and profit on his journal. The current practice is to issue currency-enfaced *mudharabah* instruments but treat them as asset-enfaced *mudharabah* instruments.

This position is analyzed and policy implications are drawn for future development of *mudharabah* instruments (Anwar, 2001).

Islamic finance introduces complications in order to incorporate recommendations of the *Shariah* advisors into, otherwise, simpler transactions. These cosmetic changes make “Islamic” transactions more expensive to the customers than similar deals through their conventional counterparts. Sooner or later the customers will realize that there is no real difference between the so-called Islamic financial products and the comparable conventional products. If this happens, then the customers may refuse to bear the extra cost on the pretense of superficial *Shariah* compliance.

In contrast, current trends and strategies of providing copious products would be self-destructive because, on the one hand, realization of truth by the customers regarding Islam city of their transactions would curtail demand for such financing products and, on the other hand, higher costs resulting from unnecessary compliance with superficial *Shariah* requirements render these products more expensive compared to similar conventional products. These factors may disappoint the customers of the Islamic banks. Therefore, it is a must for Islamic finance to improve their products by concentrating on Islamic techniques that do not contradict the injunctions of the Qur’an and Sunnah in order to benefit from the niche market.

### **III. RESULT AND ANALYSIS**

#### **3.1. Mudarabah Contract in Theory**

*Mudharabah* was a pre-Islamic custom used in order to finance a significant amount of the caravan trade in Arabia. Orientalists believe that it was adopted from the Islamic commercial practice that was in operation in the sixth century (Tamer, 2005). It is the earliest examples of a commercial arrangement and is identical with the commercial and legal institution which became known in Europe as the Command (Udovitch, 1970). Although there is no direct references to *mudharabah* in the Qur’an, those verses containing words of the same linguistic root imply a meaning of “traveling for the purpose of trade”.

Under *mudharabah*, one party, the *rabb al-mal* (beneficial owner), entrusts money to the other party (*mudharib*) to manage trustee, who is to utilize it in an agreed manner. After the operation is concluded, the *rabb al-mal* receives the principal and the pre-agreed share of the profit (Warde, 2000). Thus, if there any losses, it will be covered by *rabb al-mal* and in case of loss the *mudharib* loses only the remuneration of his efforts and his expected share in profits. There are two types of *mudharabah*, namely:

1. *Mudharabah al-Muqayyadah* (restricted *mudharabah*). Under this scheme the *rabb al-mal* may specify a particular choices of business or a particular place of business for the *mudharib*, in which case he must invest the money in that particular business or place.
2. *Mudharabah al-Mutlaqah* (unrestricted *mudharabah*). Under this scheme the *rabb al-mal* gives full freedom to the *mudharib* to undertake whatever business he deems fit (Kettel, 2010).

Therefore, *mudharabah* is regarded as a contribution to the Islamic concept of a just economic transaction. However, the characteristics of the contract vary from one law school to another. The Malikis and Shafi'is insist that *mudharabah* is a purely commercial instrument. They would reject a *mudharabah* which required any manufacturing activity on the part of the agent. To avoid any disputes, The *mudharabah* contract should specify the amount of the capital involved. This capital should not be a debt owed by the *mudharib* so that the investor cannot use the *mudharabah* to recover the debt and derive a benefit from it (Saeed, 1996). In order to avoid the possible resulting exploitation (*riba*) the *Fuqaha* have closed this back door for investor. The *mudharib* manages the *mudharabah* and should have the necessary freedom in the making decisions. According to the Malikis and Shafi'is the contract would be void if the investor, for instance, demands that the *mudharib* should not buy except from a particular person. With a profit. Furthermore, the investor cannot demand any guarantee from the *mudharib* to return the capital or the capital with a profit. Since the relationship between the investor and the *mudharib* is a fiduciary one and the *mudharib* a trustworthy person, such a guarantee would be void (Saleh, 1986). Every party to the *mudharabah* contract must know his share in the expected profit, provided the share is a percentage and not a lump sum. Before arriving at a profit figure, the venture should be liquidated and the *mudharib* is entitled to deduct all business related expenses from the *mudharabah* capital.

### **3.2. Mudharabah Contract in Islamic Banking Practice**

*Mudharabah* is considered to be the essential mode accredited by the Islamic banks in their relationship with the depositors who tender their moneys to the bank as capital owners to be invested by the bank as *mudharib* (Kettel, 2010). After entering the contract, the *mudharib* usually purchase a certain quantity of closely specified goods and sells the, to a third party at a profit. Prior to the approval of finance, the *mudharib* provides the bank with all detailed related to the good such as the source from which they are purchased and all associated costs.

Thus, it can be argued that the freedom of management has been limited sharply in Islamic Banking practice. The contract specifies in details how to manage the *mudharabah*. The *mudharib* has to ensure that correct descriptions of the goods are provided in the application for finance (Saeed, 1996). He is responsible for any losses or expenses resulting from any mistakes in the specifications since the bank does not bear such losses. He should keep the goods insured against all risks and should store the appropriately. In short, the *mudharib* must comply with the detailed terms of the contract with regard to the management of the venture and it is the bank which dictates these terms.

Furthermore, the Islamic bank takes many steps to ensure that its capital and the expected return is given to the bank on time, which is normally achieved with guarantees from the *mudharib*. Although the Shariah does not allow the investor to demand any guarantees from the *mudharib*, Islamic bank in fact seek various forms of guarantees. This guarantee serves to secure the return of funds in case of mismanagement or a lack of protection of the goods by the *mudharib*. In case that the *mudharib* is liable for a loss, he is required to compensate the bank. If

the guarantees provided are an sufficient, the *muudarib* should provide additional guarantees within a specified period.

In addition to the guarantees, the *mudharib* is required to submit periodic progress reports on the venture on both the general performance and the cash flow. Any delay in submitting these reports would lead to a decrease in the profit share of the *mudharib*. If he fails to achieve the projected cash flow, the bank itself may assume the management of the venture or can demand the liquidation of the contract without any prior warning. This means that Islamic banks almost eliminate all uncertainties involved in a *mudharabah* venture, where such a risk exists it is quantifiable and insurable. Therefore, the injunction is the bank has to bear any losses should not be taken at face value. In fact, the outcomes of *mudharabah* as practiced by Islamic banks can be considered as almost certain. This is in contrast to how the venture is envisaged by the law schools or by the Islamic economic theorist.

### **3.3. The Weakness of Mudharabah Contract in Islamic Banking**

Although *mudharabah* be regarded as ideal contract for Islamic banking, and has many advantages and "better" than the other system, but in fact, *mudharaba* is not one of the main financing schemes in Islamic banks. Based on data from the International Association of Islamic Banks (1996), *mudharaba* is only used by 20% on average in Islamic banks worldwide and also Islamic Development Bank only apply *mudharaba* contract on small projects.

Some of the problems faced by *mudharaba* contract as follows:

1. Profit-loss sharing contract associated with agency problems when an employer has no incentive to provide businesses but he has an incentive to report lower profits compared to the private financing of the manager. This argument is based on the idea that the parties to a business transaction will be neglected. If they are compensated less than the marginal contribution to the production process, and when this occurs in the case of profit-loss sharing, the capitalists hesitant to invest on the basis of profit-loss sharing. For instance, A borrow money in Islamic banks, so later he reported the profits on the income statement of business is low. Thus, the level of profit-loss sharing given to the bank is lower than the real profit.
2. Profit-loss sharing contract requires collateral in order to function efficiently. At least security of property rights on profit-loss sharing contract led to the adoption of failure because there is no standard rules.
3. Islamic banks offer lower risks of financing compared with conventional banking. It is based on the concept of *mudharabah* contract that was followed. But, the implementation of asset management profit in *mudharabah* contract is mismatch with the applicable regulations.
4. Limitation the role of investors in the management and financial structure dichotomy of profit-loss sharing contract raises uncertainty. They do not share the contract based on the participation of decision-making. In another sides, it looks that the management who manage funds while investors enjoy the results.

5. Equity financing is not appropriate for short-term project financing when exposed to a high risk level (a diversification effect on equity).

### **3.4. The Solution of *Mudharabah* Contract in Developing Islamic Financial Instrument**

The Potential problems that arise in the implementation of *mudharabah* in order to overcome its weakness can be done in several ways, namely (Muljawan, 2001):

First, Improving the quality of *mudharib* in receiving the mandate from *rabb al-mal*. Individual preferences in *mudharabah* contract will improve the quality of the transaction and it caused optimization of *mudharabah* contract among others, such as:

1. Transparency in the contract
2. The concept of respect for time, hard work and productivity
3. Trust in managing capital are given

In *mudharabah*, if the above conditions can be run by an individual, it can be said that the *mudharabah* contract produce the best quality. In addition, the increasing of individual preferences in the concept of utility would result a change of decision making and the quality of individual preferences in Islam should be a good thing. The concept of moral ethics in Islam is the concept to manage an individual to do as good as possible and can bring serious benefits as much as possible. Hence, improving the quality of preferences can be done by doing a strategic alliance with all parties that may play a role in maintaining moral values, they are, the institution of Islamic economics, as a supplier of economic actors who have a good preference, the scholars and religious leaders, religious educational institutions, and community organizations that play a role in improving public morals. As a result, the purpose of this concept is to improve individual preferences along interrelated concepts, not just the task of the bank, but it is the duty of the entire Muslim community that cares.

Second, Improving the quality of transparency in the contract such as the preparation of more detailed contracts and the using of benchmarking. To elaborate, access to impartial information can reduce the intensity of moral hazard and adverse selection in determination of optimal transaction. Also, making a detailed contract encourage transparency of information can be a solution and another important thing is the existence of benchmarking in all business sectors. For that, benchmark is easier for all parties to agree to a fair contract, for example, if talah provide the benchmark of book sales efforts, such as the average profit margin of 20%, then this benchmark can be a reference to both contracting parties, as a reference expected return.

Third, the application of adequate accounting standards. One sufficient condition determines the success of the application of the concept of *mudharabah* in society is the accounting system in accordance with this concept and also it should be able to determine the level of risk of the transaction. In short, accounting and financial system and improving of *shariah* concept will be one of the mechanisms to control *mudharabah* contract.



#### **IV. CONCLUSION**

*Mudharabah* contract is one contract that allowed in Islam which has great benefits in improving the welfare individuals and economic empowerment in accordance with the economic principles of *Shariah*. The role of the economic empowerment of *Shari'ah mudharabah* visible from characteristics of a fair, balanced, and emphasis on good achievement such work and the risks covered. The higher performance *mudharib* and the higher the risk borne *rabb al-mal* result a huge gain to be obtained. Then, the *mudharabah* encourage people to *fastabiqul Khairaat* (competing in achievement).

To optimize the role of *mudharabah* in human's life especially *Shari'ah* financial institutions by anticipation the obstacles which contained in this contract. As a result, the solution to cover the weakness of *mudharabah* contract is education and socialization to the public about the benefits of *mudharabah* refinement continuous regulation by the authorities, and participation from related parties, such as Islamic financial institutions, academics, community leaders in improving the application of *mudharabah* in *muamalat*.

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