Two-tier Mudarabah as a mode of Islamic financial Intermediation

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**Abstract**

Mudarabah as a profit-sharing instrument constitutes a vital place in Islamic finance. Islam has duly encouraged the use of profit sharing principle in business that will ensure fairness for all the parties involved. Even though the widest application of mudarabah had been in trade, it was used in all known forms productive enterprise during various periods of Islamic history. A variation of classical mudarabah, two-tier mudarabah model was widely adopted by Islamic banks. The paper discusses various aspects of mudarabah, including shariah view, legality, conditions and features. The information was collected using a library research where books, journals, articles and online resources were used. The paper further explores the role of two-tier mudarabah as a financial intermediary tool that could replace the interest based system. The Paper suggests two-tier model is the ideal method for financial intermediation. Finally, it explores the inherent problems and issues involved in mudarabah.

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**1.0 Introduction**

In an era that economic booms, bursts and calamities occurred, Islamic banking and finance has developed to an unprecedented level. As an alternative for conventional practice of banking and finance it offers a range of products based on the syariah. Interestingly, Islamic finance is viewed by modern banking practitioners as a viable solution to weather the financial crises and promote justice. The rapid development of these institutions in the last few decades has attracted the attention of both Muslims and non-Muslims. Today Islamic finance institutions provide products and services from deposits to sukuk. The potential growth of this sector is enormous. Wharton University published article (2004) outlines that Islamic banking has gone from almost nothing to an industry with assets of hundreds of billions of dollars and half of the consumer market and 10% of the assets under management in countries such as Malaysia.

This growth however has been uneven. While short-term trade financing has always been dominant and grown rapidly, mudarabah which is based on profit and loss sharing has always been considered to be at the core of Islamic financing and in tune with the shariah injunctions against interest based financing (Bacha, 1997). Mudarabah financing as an alternative to conventional debt financing relies on profit loss sharing principle. Unlike conventional debt built on interest or riba in mudarabah financing capital provider assumes some sort of risk in financing. However, mudarabah has seen some set backs with this growing sector only account for less than ten percent of all transactions of Islamic banking and finance world-wide. Efforts have been taken to promote the profit loss sharing products as preferable modes of financing in Islamic finance.

As in classical mudarabah contract, it is not viable for Islamic financial institutions (IFI’s) to be directly involved in businesses by managing every aspect of the enterprise. It is not possible for financial intermediaries as Islamic banks to form new businesses in order to inject the capital. A two-tier mudarabah version that sees an islamic bank as a simple financial intermediary whose only role is to channel venture capital from savers to businesses. Two-tier mudarabah is a viable basis for Islamic banking whereby Islamic banks play the role of a financial intermediary. It should be understood that practice of mudarabah in IFIs take place in the form of two-tier or multiple mudarabah. The paper intends to discuss various aspects of classical mudarabah and two-tier mudarabah as practiced in IFI’s. This includes the discussion of ideal financial intermediary function that is opposed to interest based system. A meaningful discussion of conventional and Islamic banking intermediation will shed the light on adverse impacts of conventional banking.

**2.0 An overview of Mudarabah**

**2.1 Profit Sharing in Islam**

In the Islamic system money capital cannot be hired. Money capital owned by others can only be obtained by a firm as interest-free loan or on the basis of profit-sharing. This does not apply however, to the other factors of production e.g. labour, land and physical capital. In so far as the firm does not own them, it can either hire the services of these factors or acquire their services on a profit-sharing basis (Siddiqi, 1991). As scholar Siddiqi (1991) highlights, a labourer, skilled or unskilled, the owner of land or the owner of capital goods can either obtain salaries, wages, rents or rentals respectively by hiring out their services or assets; or by exposing themselves to some risk may enter into a profit-sharing arrangement with the user, the firm . In his article Hassan mentions the importance of mudarabah in following terms:

Mudarabah was one pre- Islamic institution that expanded fast in the Muslim lands over time and became the most thriving form of business financing by the dawn of the thirteenth century. Naturally, in the modern era of Islamic resurgence, the School saw the theoretical foundations of Islamic banking and finance more in the instrument of mudarabah based participatory finance though Musharakah was never ignored. (p.5)

Mudarabah, an Islamic profit sharing alternative to interest based finance, had been used throughout the Islamic world between merchants and moneychangers since the time of the Prophet Mohammed (pbuh), (Wilson).Even though the widest application of mudarabah had been in trade, it was used in all known forms productive enterprise during various periods of Islamic history. Profit-sharing between the supplier of money capital and the one actually using it in business wits, being practiced in Arabia and elsewhere on the eve of Islam (Siddiqi, 1991).

The instrument and institution of profit sharing under economic cooperation, known as mudarabah is central to resource mobilization in the Islamic economic order (choudhury, 1989). By being the most acceptable form of institution and instrument of transaction in the Islamic economic order, mudarabah is aimed at replacing interest transactions totally by profit sharing rates and returns. Interest charged on the use of capital is an economic excess as it is not a real cost of production (choudhury, 1989). This is in contravention to the shariah and the main principles of the Islamic order. The ability to abolish interest based capital requirements makes Mudarabah the center piece of Islamic transactions.

**2.2 The Concept and Fiqh View**

As evident from various books of fiqh, the term mudarabah is interchangeably used with Qirad and Muqaradah. It is presumed that while the latter two originated in Hijaz, Mudarabah was of Iraqi origin (Ayub, 2007). Subsequently the difference appears to have been perpetuated by the legal schools, the Malikis and shafi’es adopting the terms “Qirad” and “Muqaradah” and the Hanafis using the tem “Mudarabah” (Ayub, 2007).

Though the two terms are argued to have been used to emphasis two different meanings. As mudarabah is an elaboration of the functions or work mudarib while qirad emphasises the fact that rab al-mal has given part of his capital and part of his profit to mudarib (Incief). However this is outlined only in their litteral meanings. Moreover, the term Mudarabah is derived from the expression which means to make journey (Ayub, 2007). It could be related that journey is an inevitable part of workers life in the course of business. Mudarib is the investor’s partner in the profit and in the capital used on the journey and in its disposition. In Quran Allah says, “While others travel in the land in search of Allah’s bounty”. That is to say, travel for the purpose of trade.

Mudarabah in classical literature is defined in different ways by jurists. The Malikis connote mudarabah as an agency for trading in delivered cash for a profit while for shafis it is an agreement between rab al-mal (capital provider) and mudarib (worker) to share in profit (Inceif). Hnabali definition constitutes similar to Shafi understanding which a person gives his capital to another for business in order to share the profit according to their stipulation (Inceif). The most graspable and coherent definition on the matter is given by the Hanafi school of law. They define mudarabah as a partnership for participation in profit in which capital is provided from one side, whereas labor or skill is from the other side. Bank Negara Malaysia defines in its draft shariah parameter that the Mudarabah contract is a form of partnership between one who contributes capital and the other who contributes efforts in the form of managerial skills. Despite various definitions given by the scholars’ mudarabah is simply an act of one party giving away his property as capital to a person for him to work with that capital. If business produces profit it is shared between the rab al-mal and and mudarib at a pre-agreed ratio. In case of a loss the entire portion is borne by the rab al-mal while mudarib will loose his labor and receives nothing out of the venture.

* 1. **Mudarabah Financing in IFI**

In Mudarabah financing, one party, the Rab-Ul-Mal or financier, provides the capital, while the other party, the mudarib, provides the entrepreneurship and effort to run the business. The underlying contractual relationship is that of a partnership, with the Rab-Ul-Mal as the silent or sleeping partner. Profits derived from the business or investment is shared by the two parties according to a predetermined profit-sharing ratio. This could be, for an instance 70:30, or 80:20, with the larger portion accruing to the mudarib. In the event of losses, the Shariah stipulates that all losses must be borne by the financier. Any party may terminate the Mudarabah agreement at any time. In a Mudarabah arrangement, the financier is not allowed to interfere in the running of the business. Thus, a Mudarabah arrangement looks very much like an equity investment by a shareholder in a public listed company. In fact, Islamic banks consider Mudarabah financing to be the equivalent of equity financing.

Mudarabah contract is applied in deposit taking arrangement such as current account, savings account and investment account. The contract is also applied in inter-bank investment and Islamic bonds. In takaful industry, mudarabah contract is used as one of the operational model as well as being applied for investing the takaful funds.

However, given the features and the underlying Shariah law, Islamic bank Mudarabah financing is really a hybrid. It is neither equity nor debt because it has to a mudarib, the financing that he gets from an Islamic bank is like conventional equity (Bacha, 1997).

Author Bacha (1997), in his article states following reasons as to why it appears to be in the form of conventional equity.

1. there are no ''Fixed'' annual payments that are due (unlike interest)
2. payments made to the Islamic banks come from profits, much like dividends -- they need be paid if and only if there are profits;
3. the Islamic bank cannot foreclose or take legal action if there are no profits and therefore nothing to be shared; and
4. like equity, using Mudarabah financing does not increase a firm's risk the way debt financing does through increased financial leverage.

On the other hand, Mudarabah financing can appear to the mudarib as a conventional debt for the following reasons (Bacha, 1997) :

1. It represents a “fixed” claim by the Islamic bank on his company, being the initial amount plus whatever accrued profits (or losses) that are due to the bank.
2. like debt, Mudarabah financing is terminal, that is, the arrangement can be ended either by mutual prior agreement or by one party. The mudarib can end the relationship by repaying the principal and accrued profits to the Islamic bank.

In modern Islamic finance, mudarabah is commonly done on a two-tier system (Islamic finance, 2009). Multiple depositors invest money into an Islamic bank. This will be discussed in more detail in the latter part of the paper. The bank then acts as the investor in a variety of entrepreneurs, and shares profits (and losses) with the original first-tier depositors. By adopting a two-tier mudarabah version that sees an Islamic bank as a simple financial intermediary whose only role is to channel venture capital from savers to businesses. Therefore the discussion of mudarabah as a financing product in Islamic banks necessarily means the two-tier mudarabah version practiced by these institutions. It could be noticed that one-tier model is impossible to be followed and could jeopardize the functions of a financial intermediary.

On the other hand, the takaful industry contains contrasting examples of the application of mudarabah. Looking from a purely mudarabah perspective, a properly constructed mudarabah is found in family takaful (Idris). However, it is not in the ambits of this paper to discuss takaful models.

1. **Legitimacy of Mudarabah Contract**

The following Quranic verses imply the general permissibility of commercial ventures including Mudarabah.

i. “…others travelling through the land, seeking of Allah’s bounty…”

(Al-Muzammil: 20)

ii. “And when the Prayer is finished, then may ye disperse through the land, and seek of the Bounty of Allah; and celebrate the Praises of Allah often (and without stint): that ye may prosper.” (Al-Jumu`ah: 10)

These verses do not directly address the permissibility of Mudarabah but are interpreted to imply Mudarabah by referring to those who travel for the purpose of trading and seeking permissible income including those who undertake labor with someone else’s capital in exchange for part of the profit (Draft of shariah parameter).

A number of sayings of the holy prophet (pbuh) and reports by his companions on the subject indicate that Islamic jurists are unanimous on the legitimacy of mudarabah. The terms of the mudarabah contract offered by the prophet’s uncle abbas were approved by the prophet approved by the prophet (pbuh). Abu Musa the governor of Kufa, wanted to remit public money to the Bayt al mal. He gave the amount to Abdullah bin Umar and his brother, who traded with it. The Caliph’s assembly treated it as an ex post facto Mudarabah and took half of the profit earned by two brothers, because the public money in their hands was not loan. Caliph Umar also used to invest in orphans property on the basis of Mudarabah (Ayub, 2007).

With regard to legality of Mudarabah, Ayub (2007) quotes Al- Marghinani in Al hidaya:

“There is no difference of opinion among the Muslims about the legality of Qirad. It was an institution in the pre-islamic period and Islam confirmed it. They all agree that the nature of the mudarabah business is that a person gives to another person some capital that he uses in the business. The user gets, according to conditions, some specified proportion, e.g. one third, one third or even one half.”(pg.321)

Moreover, some verses from Al-Quran have been recognized by jurists to indicate the legality of mudarabah. For instance, Allah says “Others travelling through the land seeking of Allah’s bounty”. Although verse does not directly address the practice of mudarabah, jurists interpret it as a compliment or encouragement for those who travel for trading, seeking legitimate income, including those who work for another’s capital in order to reward their effort or labor by parting to the profit.

In sunnah legality of mudarabah is derived by the tacit approval of the prophet (pbuh). Islamic jurists agree that tacit approval of Prophet (pbuh) alone is adequate enough to validate the practice of mudarabah. However, difference of opinions exists among jurists as far as analogy is concerned. According to some jurists Mudarabah defies the analogy and for others it could be construed by analogy (Inceif). Legality of mudarabah has been endorsed by sunnah as the tacit approval of the prophet is an acceptable evidence.

1. **Features of Mudarabah Contract**

Mudarabah, like other contracts should be used for lawful items of trade, failing which the contract will become void or voidable. The classical jurists generally restricted the use of Mudarabah to the act of trade which involved buying and selling (Ayub, 2007). But an overwhelming majority of jurists allow mudarabah contracts in Islamic banks as a viable alternative to interest-free banking (Ayub, 2007). In general the contract of Mudarabah allows anyone of the contracting parties to terminate the contract unilaterally. The contract shall not be terminated unilaterally if the manager has commenced the work or when both parties have agreed not to terminate the contract during a specified time (Draft of shariah parameter).

**4.1 Agreement in Mudarabah Contract**

As for other permissible contracts, agreement for mudarabah contract is concluded linking the acceptance to the offer. This agreement could be concluded in many forms but it should retain the meaning of mudarabah (INCEIF). Majallah stipulates following as regards to the agreement:

A person processing capital asks some other person to take capital and use it to share the profits between them equally, or in the ratio of two or thirds or one third. Or says something indicative of an intention to form a mudarabah contract, as when he asks such a person to take so much money and use it as capital and share the profits with him in a certain ratio and latter accepts. A mudarabah contract has been concluded.

A mudarabah contract may not be concluded in the absence of two contracting parties with absolute legal capacity or their agents who enjoy legal capacity similar to that of the contracting parties (INCEIF). The religion of the party is irrelevant according to the majority of schools of law with the exception of the Malikis.

**4.2 Mudarabah Capital**

Capital is the principal feature of mudarabah forming the substance of the contract. The capital shall be contributed by the capital provider only. The capital shall be managed by the mudarib to generate income. In a two-tier mudarabah model IFI acts as a mere intermediary to pool funds from investors. The depositors or investors who have agreed to invest in mudarabah financing will be the genuine capital providers or rab al-mal. The capital of mudarabah may be in the form of monetary or non-monetary assets (Draft of shariah parameter). However, Ayub (2007) states that the value of illiquid assets should be clearly ascertained in terms of legal tender when entering to the mudarabah contract and should carry no ambiguity of the value. Moreover, valuation of tangible assets shall be based on the valuation determined by a third party who may include authoritative bodies, experts or valuers, or as agreed upon by the contracting parties at the time of conclusion of contract (Draft of shariah parameter). Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) upholds this opinion, originally given by Ibn Abi Layla and Al-awazi. In a two-tier mudarabah model financial institution may contribute capital in form of non-monetary but in tangible form. Following illustration would be helpful in understanding in a two-tier mudarabah frame work.

A public transportation company, KL Tranz, has applied for Mudarabah-based financing from BMB Bank. The bank approves the application and agrees to provide ten (10) buses to KL Tranz as Mudarabah capital valued at RM10 million based on prevailing market value and KL Tranz should manage the operation of these buses.

However, this rule does not necessarily represent the opinion of Hanafi, Maliki and Hanbalis, that disallow the use of asset it self in the business. According to these jurists the assets must be sold and proceeds could constitute as mudarabah capital (INCEIF).

Debts such as account receivables or loans due to a capital provider do not qualify as capital of Mudarabah (Draft of shariah parameter). AAOFI in its standard on Mudarabah does not permit debt owed by the mudarib or another party to the capital provider as capital in a mudarabah contract. Capital injected in to a mudarabah venture should be free from any kind of liability. This also restricts usurious loans being used as capital which capital provider would ensure recovery of capital and illegal return on his loan.

Agreed capital shall be made available to the manager to commence the business activities. The capital may be fully or partially disbursed or made available to the manager at the time of the conclusion of the contract and based on terms of the contract. Capital provider and manager may agree for a gradual withdrawal of mudarabah capital by the capital provider. Failure to provide capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to specified terms and conditions of the contract. The manager has an option to terminate the agreement or both parties may agree to revise the agreement based on actual capital contribution (Draft of shariah parameter). Where the agreement is terminated the manager has to return the outstanding capital (if any). If the mudarabah expenditure exceeds the actual capital contribution, such liability shall be borne by the capital provider up to the limit of the total amount committed under the contract (Draft of shariah parameter). Mudarib may inject its own fund into the mudarabah capital which will transform the initial mudarabah contract into a musharakah arrangement (Ayub, 2007).

**4.3 Managing the Mudarabah Venture**

The mudarib shall have the exclusive right to manage the Mudarabah venture. The capital provider shall be precluded from managing the venture. However, the capital provider has the right to information regarding the conduct of the manager. It is only according to Hanbali jurists and to some extent, Hanafi jurists that the owner is allowed to work for the business with the mudarib. The reason for disapproval by the majority of jurists is that it jeopardizes the freedom of the worker to act according to his discretion (Ayub, 2007). This is clearly described in the illustration given in BNM, Draft of shariah parameter for mudarabah contracts:

In formalizing the Mudarabah financing agreement, the capital provider specifies a condition of its involvement in the pricing strategy of the venture. At the same time it also requests periodic reporting of the performance of the venture. Based on the terms of the Mudarabah contract, any involvement in pricing strategy of the venture by the capital provider implies management interference and hence is not permissible. However, periodic reporting which allows effective and timely supervision of the venture without any intervention in the management of the venture is allowed (p.9)

According to Ayub (2007), it now seems more reasonable to allow the owner to ensure honesty and efficiency of the worker by taking a personal interest in the affairs of the business. The mudarib shall not be liable for any loss of capital unless such loss is due to the mudarib negligence, dishonesty, misconduct or breach of terms of the contract. Among the typical conditions specified in the Mudarabah contract is that the managing partner is to exercise due care and diligence. He should also disclose all relevant information that is significant for the capital provider to form a decision to proceed with investing in the venture (Draft of shariah parameter).

**4.4 Profit Sharing in Mudarabah**

Profit Sharing is the primary motive of the Mudarabah contract. The profit sharing may be based on a ratio or percentage to be agreed upon by all partners. The profit sharing ratio shall be determined at the time of the conclusion of contract and may be revised from time to time during the contract subject to mutual agreement (Draft of shariah parameter). As a principle, in mudarabah it is only the financier who bears the loss. Mudarib wil not share the loss unless proven negligence or breach of contract. It is not permissible to include a condition in Mudarabah contract that stipulates a pre-determined fixed amount of profit to one partner which deprives the profit share of the other partner (Ayub, 2007).

The parties to the contract may agree to set aside a portion of the profit as a reserve (e.g. profit equalization reserve) or for any other purpose (Ayub, 2007). However, for capital protection purposes, the reserve may only be taken from the profit portion of the capital provider (Draft of shariah parameter). The loss can be compensated from the profit of the future operation of the joint businesses or the reserves created in the past. Parties can change the ratio for profit distribution at any time, but that ratio will remain effective for the period it has been mutually fixed. The mudarib cannot claim any periodic salary, fee or remuneration for the work done by him for the mudarabah business. However, he is allowed to draw his daily expenses of food only from the mudarabah account.

One of the main features that distinguish single tier and two-tier mudarabah is the profit sharing among parties. In a single tier relationship only one profit sharing agreement would exist. In a multi-tiered or two-tier Mudarabah contract, two or more profit sharing arrangements may be agreed between investor and IFI followed by IFI and the manager (Draft of shariah parameter). The profit generated by the manager shall be shared with IFI according to the agreed profit sharing ratio which then is redistributed between the IFI and the investor (rabb al-mal) based on the earlier pre-agreed ratio. The following illustration explains this scenario.

A one year restricted Mudarabah fund of RM500, 000 with a profit sharing ratio of 80:20 between the investor and the Islamic financial institution is established for project financing. With the fund the Islamic financial institution provides one year project financing based on Mudarabah with an agreed profit sharing ratio of 70: 30 between the IFI and the customer. At the end of the year a profit of RM 300,000 is recorded from the project. The profit is distributed as follows:

|  |  |  |  |
| --- | --- | --- | --- |
| Partners | Total Profit (RM) | PSR | Distributable Profit (RM) |
| First-Tier Profit Distribution | | | |
| IFI (Investors) | 300,000 | 70 | 210,000 |
| Manager | 30 | 90,000 |
| Second-Tier Profit Distribution | | | |
| IFI (Manager) | 210,000 | 20 | 42,000 |
| Investors | 80 | 168,000 |

Above table shows the profit distribution among involved parties in a two- tier mudarabah venture. If the bank provides its own funds it is entitled to get a profit on its own capital in proportion to the total capital of the mudarabah (Ayub, 2007). Any unusual investment income from Shariah prohibited activities of a mudarabah venture due to extenuating circumstances may be distributed as charity.

Loss shall be recognized when the liability exceeds the value of the assets at a point in time from a balance sheet perspective. Alternatively, when expenses exceed revenue for a defined period, an operating loss shall be recorded. Mudarabah operating loss which is measured during the operating period may be offset against prior or future profits (Draft of shariah parameter). Loss shall be solely borne by the capital provider except in the event of misconduct, negligence or breach of contract by the manager.

**4.5 Termination of a Mudarabah Contract**

Upon agreement to provide capital or disbursement of funds, the capital provider may withdraw the capital from the venture prior to commencement of the business venture subject to term and conditions. The general principle is that the Mudarabah is not a binding contract and each of the parties can terminate it unilaterally except in two cases. The Mudarabah contract shall be binding in the following events (Ayub, 2007):

1. When the manager has commenced the business. In this event, the contract is binding up to the date of actual or constructive completion.

ii. When the duration or the termination date of the contract has been determined. However, the contract may be terminated earlier based on a mutual agreement by the parties.

For termination, the mudarib will be given time to sell the illiquid assets so that an actual amount of profit may be determined. In general, the Mudarabah contract may be terminated due to the following circumstances (Draft of shariah parameter):-

* Unilateral termination by any of the parties when the Mudarabah does not constitute a binding Mudarabah.
* Mutual agreement to terminate between the parties.
* The contract expires as at the maturity date agreed by the parties.
* The impairment of the Mudarabah fund does not favor the continuity of the venture.
* The demise of the manager or the liquidation of the managing institution
* The existence of one of the conditions that would consequently render a Mudarabah contract invalid. In this case, the mudarib is deemed as the worker/agent who deserves fair and reasonable wages or fees only.

The non-binding effect of Mudarabah contract gives the parties to terminate contract unilaterally, which could hamper modern day business undertakings. These businesses need time to bear the fruit, and continuous and complex efforts to grow. Therefore if the parties agree, while entering into the mudarabah, that no party shall terminate it during a specified period, except in specified circumstances. This is in light with the Hadith that mentiones, “All the conditions agreed upon by the Muslims are upheld, except a condition which what is prohibited or prohibits what is lawful in Syariah”

In practice IFI that uses two-tier mudarabah model would rescind the contract anytime that breach of conditions occur to secure the capital provided by its investors. Although it is not directly involved in the management of mudarabah venture it should be vigilant of mudaribs operations, this would uphold the investor and depositors interest in IFI. The Following illustration shows the IFI terminating Mudarabah contract due to shortcomings of the mudarib (Draft of shariah parameter).

Mudarabah financing for a period of two years provided by an IFI to the customer is reviewed quarterly in terms of the manager’s compliance and performance of the funds. In the third quarter of the 1st year it was found that the performance of the fund exceeds expectation and additional financing was granted. Profit was distributed at the end of the first year and the approved capital remains outstanding in the second year. In the second quarter of the second year, the manager activities failed to observe the scope of the financing requirement and thus violated the conditions specified in the contract. The customer appealed to ratify and the financing period continued. However in the third quarter capital is impaired as 50% of the fund is lost. As a result the contract is voidable and IFI has the right to rescind the contract and held the manager liable for any loss due to the violation of the contract (P.22).

**5.0 Types of Mudarabah**

IFI can involve in mudarabah business in two formats: restricted or unrestricted mudarabah. The scope of the restricted Mudarabah contract may specify conditions restricting the manager’s functions such as determination of location, period for investment, type of project and commingling of funds, provided it does not nullify the purpose or objective of the contract. In addition, there may be other restrictions which investment account holders may impose. For example, investment account holders may require the Islamic bank not to invest their funds in installment sales transactions or without guarantor or collateral or require that the Islamic bank itself should carry out the (Hameed, 2007). However, the restrictions shall not unduly constrain the manager.

On the other hand unrestricted Mudarabah capital is the capital deployed in the Mudarbah contract which does not specify any limiting conditions and the manager is given the discretion provided he acts in the best interests of the capital provider. In IFI, both forms could be used to attract investors for bank to invest in another customers business. Account holders and the Islamic bank generally participate in the returns on the invested funds (Hameed, 2007). Following illustration helps to understand the restricted and unrestricted concept in two-tier model used by the IFIs.

Mumin bank launches a Mudarabah investment fund which does not restrict the scope of investments in terms of location and sectors. Mumin bank has the liberty to manage and invest the fund in a manner that serves the best interests of the investors of the Mudarabah fund. This qualifies as unrestricted Mudarabah fund.

As a financial intermediary Islamic bank could retain its status as one who manages fund. However, investment by bank could be restricted to certain businesses by the investors. Accordingly, a mudarabah contract could be conditional or unconditional. The conditions may pertain to the nature of the work, the place of work or the period of the work. Conditions binding the worker to trade with a particular person or in a particular commodity, etc. are according to Hanafi and Hanbali jurists, permissible, but these make the contract a special mudarabah (Ayub, 2007).

IFI that calls funds under two-tier mudharabah contracts for both restricted and unrestricted mudarabah create liabilities and assets. In the liability side, the investment depositors as the fund provider and the bank are involved in the contract of mudharabah (Zainab and Zainuddin). On the financing side, banks, who received fund from depositors act as a financier to the entrepreneurs who borrowed the money from the banks (Zainab and Zainuddin). IFI in its part is bound to follow the investors’ conditions. If it violates a restriction or contravenes a beneficial condition, it becomes a usurper and will be responsible in respect of capital to the investors.

Survey and analysis by Ismail and Abdul Latif (2001) on financial reporting of Islamic banks shows that the main difference between standards produced by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and selected Islamic banks in Malaysia including Islamic bank is in classification of deposits’ funds and the particular prominence that is given to restricted investment accounts and unrestricted investment accounts from other deposits like current and saving.

**6.0 Evolution of Two-tier model in IFIs**

Baqir Al Sadr, an Iraqi scholar, made a notable contribution with a book on interest free banking in Islam that was first published in Kuwait in 1970 and later translated into Urdu (Wilson). He distinguished between a client depositing money with a bank and the bank advancing funds to a client. Both transactions could be covered by mudarabah, with the depositor sharing in the bank’s profits and the bank sharing in the profits of the enterprises it supported (Wilson). In fact, the bank was envisaged to provide money to a firm, the entrepreneur, in all participatory contracts on a PLS basis (Hasan). The sharing of profit between the bank and the firm is but one half of the story. The other half relates to profit sharing between the bank and its depositors.

The preference for mudarabah provided much food for thought and opened numerous possibilities for the modeling of Islamic banking. The historical, puritan model the owner of capital provided the entire funding to the entrepreneur-operator and had nothing to do with the management of business (Hasan). The contract between the parties stipulated a share for the financier in the profits of business while he alone would bear the loss, if any. Usually the contract was for the execution of a specific project. The model suited to and worked well in a community where trade was the dominant occupation. With the rise of modern corporations working on the principle of limited liability as the dominant form of business organization, the puritan model of mudarabah lost much of its significance (Hasan).

There were two major points of departure. First, today businesses contributing bulk of the output in modern economies are founded on a large scale, not for executing short-run piecemeal ventures, but for running the ongoing sort of manufacturing or trading activity (Hasan). Second, financiers usually provide only a part of the total capital, not all. It is in this light that the usefulness of the financing modes for Islamic institutions has to be evaluated (Hasan). These institutions act as outside financiers providing for a specified period just a fraction of the needed investment (Hasan). They may not also be willing to avoid supervisory role to safeguard their interest. Interestingly, the problems a puritan design poses under the changed circumstances were anticipated quite early and discussions on the modus operandi of the mixed sort of mudarabah structures did make their appearance in some of the pioneering works on the subject (Hasan).

**7.0 Illustration : Single and Two-Tier Mudarabah**

**Single Mudarabah**

**Islamic Bank(Mudarib)**

**200,000 (70:30) 200,000**

**24,000**

**%30**

**Investment**

**$200,000**

**Rab Al Mal**

**If profit= 56,000 (70%)**

**If Loss = (80,000) (100%) Profit/Loss**

P**rofit/(Loss)**

**$ 80,000/($ 80,000)**

**Two-tier Mudarabah**

**100,000 (60:40)**

1biraduM

(knab cimalsI)

2 biraduM

(remotsuC)

**100,000 (70:30)**

**$9,000/($ 0)**

**Investment**

**$100,000**

**$ 20,000/ ($0)**

**Depositor**

P**rofit/(Loss)**

**$ 50,000/($30,000)**

**Profit/Loss**

**$21,000/($30,000)**

**8.0 Modus operandi of Two-tier Mudarabah**

The arrangement can be made adopting two-tier mudarabah agreement. The first tier of the mudarabah agreement is between the bank and the depositors, who agree to put their money in the bank’s investment account and to share profit with it. In this case, the depositors are the capital providers (rabb al-mal) and the bank function as a manager of the funds. The second tier of the mudarabah agreement is between the bank and the entrepreneur who seek financing from the bank; who agree that the profits accruing from the business will be shared between them and the bank in an agreed proportion, but the loss shall be borne by the financier only. In this instant, bank functions as the provider of the capital and the entrepreneur works as a manger. In cases where there is more than one financier of the same project (one project jointly financed by several banks), profits are to be shared in a mutually agreed proportion previously determined,but loss is to be shared in the proportion in which the different financiers have invested the capital.

The rate of return is agreed on after expenses have been deducted. On the other hand, the one-tier Mudarabah is a contract between the bank and the money borrower, to provide capital for a specific project. The difference between the two-tier and one-tier system, is that the one-tier Mudarabah only includes the bank and an investor. However, in a two-tier system, there is the bank, an investor and a money borrower and this works as a stock company.

Following is a module that helps the bank manage funds by accepting deposits and deploying funds appropriately, for financing and investment (Islamic Banking Solutions). Key features include the facility to:

• Define an Islamic pool to mobilize funds, deploy it and also manage profit distribution for deposits (between bank and depositors).

• Specify a pool as restricted or unrestricted, based on various pre-configured restriction types like country and sector, which are bank-definable parameters.

• Specify subscription period for an identified pool.

• Define multi-currency pool and track pool balance in individual currencies.

• Specify an indicative profit rate for the pool, as the approximate rate applicable to the customer.

• Define management fees to be collected for the pool.

* Define capital loss provision, profit equalization provision and profit normalization contribution as required by the bank.

• Specify profit distribution frequency for a pool.

• Define tenor-based profit sharing percentage (between bank and customer).

• Compute profit based on variables like profit and loss from asset investment and inter-pool Investment.

• Distribute profit to customers based on the cumulative weighted average balance of customer deposits – taking into consideration the tenor of deposit, amount of deposit, number of days the deposit has run as on profit distribution date and the profit sharing ratio.

**9.0 Two-tier Mudarabah and Financial Intermediation**

The role of the bank as a financial intermediary is an entrepreneurial role. Its essence lies in choice between alternative opportunities of profitable placement of funds entrusted to it for this very purpose by its depositors (Siddiqi, 1991). It is possible to argue that the depositor could hire the bank's services for this purpose i.e. the bank relinquishing its entrepreneurial role in favor of a mere managerial one. The bank would get a fixed fee from its depositors who would then claim the entire profits accruing to their funds (and incur the losses if any). However, such an arrangement will be substandard than a profit-sharing agreement between the depositors and the bank. In case the banks receive a fixed fee for their services the incentive to maximize profits is not as strong as it is in the case it which bank's income is a percentage of the actual profits (Siddiqi, 1991). The moral hazard implicit in any arrangement between the depositors and the bank is also larger in the fixed fee case (Siddiqi, 1991).

The worst and the least efficient and the most unfair arrangement would be that in which the intermediary (bank) promises to pay the depositors a predetermined percentage return, as it is in the interest based system (Siddiqi, 1991). Its only advantage is that it almost eliminates the moral hazard involved in the other alternatives. The commitment to pay a predetermined return to the depositors obliges the intermediaries (banks) to confine their choices to those alternatives which bring in a predetermined return higher than those claimed by depositors. Their safest bet becomes loans to borrowers with high credit ratings. These are not necessarily the people whose projects are the most productive. Interest as a basis of the arrangement between the depositors and the intermediary is unfair because by obliging the intermediary to seek predetermined returns its shifts the entire risks of using funds in business enterprise on to the ultimate users. Since man's economic environment does not guarantee positive returns to all users of funds all the time, it is unfair for fund owners to insist on that guarantee. It can come only at the cost of some other group in the society.

The best, and the most efficient and the fairest arrangement between fund owners and financial intermediaries is that of profit-sharing. Despite the fact that it does involve moral hazard (Siddiqi, 1991). It is efficient as it makes the reward of the intermediary a function of the actual profits realised as a result of his choice. The intermediary's choice is in principle unconstrained. He can very well go in for financing the most promising projects available. A profit-sharing arrangement, simple or otherwise, between the intermediary and the ultimate user of funds in productive enterprise is the logical consequence of the profit-sharing arrangement between the intermediary and the depositors (Siddiqi, 1991). Such an arrangement encourages the fund users to maximize profits without burdening them with a predetermined cost of capital.

Venture capital (VC) in conventional financial system has similar roots to two-tier mudarabah where it channels the funds to promising businesses. Most of the aspects involved in VC are in line with principles of mudarabah or Shirkah. Islamic banks and VC companies have these common roots and that follow a two-tier mudarabah structure. The first level can be said to be the collection of funds. In Islamic banks, the investment account holders are people who participate in the bank’s investments in order to share in the resulting profits under mudarabah. On the second level, too, both Islamic banks and VC companies play the same role, that of mudarib or agent. Acting as an agent for their investors, they invest the investors’ funds in a multitude of entrepreneurial companies and pass a proportion of the profits back to the investors, along with capital and gain where appropriate. Thus it is a valid point to make that, financial intermediation function through Mudarabah is a successful arrangement in contrast to conventional system that lends and borrows for fixed terms.

**9.1 Profit sharing as the ideal Financial Intermediation**

Fairness is best ensured by profit-sharing arrangement as rewards are a function of realized productivity all along the fine: The fund owner, the financial intermediary and the ultimate user of fund in productive enterprise each get a share out of the value added. When the economic environment fails to add any value, or when it erodes part of the value invested in the venture, all the three share in the misfortune; the fund owner loses part of his funds and the intermediary as well as the ultimate user of fund in productive enterprise go unrewarded for their services. Profit-sharing is harmonious with the nature of man's economic environment on both sides of the intermediating institution, with the fund owners as well as with the fund users.

An unfair distribution of the value product between the three parties involved (i.e. fund owners, intermediaries and fund users) ultimately affects efficiency by affecting the generation of, funds (i.e. savings), distorting their allocation and weakening the incentive for their best use and effective management (Siddiqi, 1991). This is when value is not created but one side of the axis (lenders) continues to profit unfairly. An unfair arrangement is bound to become an inefficient one. Financial arrangements which guarantee a fixed return or reward to any of the three parties involved in a situation in which the value product is not and cannot be predetermined, are unfair as well as Inefficient. The only fair and efficient arrangement in such a situation is profit-sharing.

It may be argued that conventional Western banks play essentially the same role of agent between their depositors and the businesses they invest in. There is a difference, which has important implications for the depositors. Instead of sharing in the profit or loss of the companies they invest in, conventional banks charge these companies a fixed rate of interest and give their depositors also a fixed, but lower, rate of interest. Making their profits from the difference between the two levels of interest, the banks are not participating in any real sense in the fortunes of the businesses they invest in. Indeed, it is as though the bank had erected a wall between the two.

Replacement of interest by profit-sharing has far reaching implications for allocation of investible resources, distribution of the value added and the cash flow in the system (Siddiqi, 1991). On the international scene, this change would link influx of foreign capital in a country to real productive possibilities in that country (Siddiqi, 1991). The factor of compound interest being absent, repayment and other entitlements of foreign capital will all be in accordance with the realized results of using that capital. Once the returns to financial capital are made contingent on the realized results of its use the scope of speculative capital movements across the globe will be severely curtailed (Siddiqi, 1991)

**10.0 Issues in Two-tier Mudarabah Model**

Despite the higher profit potential of mudarabah financing in principle, and ability to challenge the interest based system, the mode could not make a breakthrough change in modern Islamic finance. It did blossom as a deposit collecting mechanism with the Islamic financial institutions (Hasan). For example, mudarabah companies multiplied fast, especially in Pakistan. But these companies could not find business investment opportunities sufficient to absorb bulk of the deposits they received (Hasan). They were compelled, in a sense, to make money in speculative buying and selling of shares at the stock markets.

One of the major practical problems with mudarabah was the asymmetrical nature of the risks involved (Wilson). For the bank depositor the major risks were of bank failure and the uncertainty regarding the level of profits to be shared. With effective bank regulation the risk of bank failure was minimal however, and uncertainty even applies to variable interest returns, so this was unlikely to deter depositors, indeed it was the slight risk they took that justified their reward. The more serious problem with mudarabah arose with bank financing of business, as there was no guarantee that the bank could get their funds repaid. Furthermore the risk of getting no profits was considerable, especially with the type of small businesses that characterized many Muslim economies (Wilson). There were also moral hazard problems, as businesses could potentially disguise the profits they made to minimize the profits shared, especially where full audits were not required.

Theses major setbacks caused Islamic banking and finance to follow the course of least resistance and to take refuge in the reckless use of Islamic deferred obligation contracts. The model that could have challenged the conventional banking if meticulously introduced let to fail. Currently, Islamic banks have virtually no place for mudarabah contracts in their Islamic products menu. In Malaysia by year 2003, mudarabah accounts for zero percent of total banking products (Hasan). High defaults in mudarabah contracts have always been the problem for Islamic banks. However, in my opinion bank should employ a rigorous process to evaluate the mudarib and business venture that it intends to invest. The standard method of selection of mudarib or business should be able to identify the most creditworthy customers and viable businesses.

**11. Conclusion**

The instrument and institution of profit sharing under economic cooperation, known as mudarabah is central to resource mobilization in the Islamic economic order. Mudarabah is one of the most acceptable forms of instrument which is based on shirkah or profit sharing. Interest charged on the capital, is in contravention of shariah does not represent cost of production. Therefore Islam highly advocates profit sharing which mudarabah plays a vital role of channeling the surplus funds to deficit units in modern Islamic banking and finance.

The two-tier mudarabah model represents an ideal mode of financial intermediation that could replace the interest based system. Interest based system being oppressive, does not assume any risk of providing capital regardless of the outcome of enterprise. The interest bearing instruments therefore leads the economy in to an inefficient state oppose to profit sharing that is engaged in value creation. Fairness is best ensured by profit-sharing arrangement as rewards are a function of realized productivity that channeled to all the involved parties. In to that, Islamic bank as a deposits accepting institution differs from a conventional at this juncture, where by facilitating entrepreneurs to share the risk.

Despite the fact it is regarded as a driving feature of Islamic finance, model has been hit by major barriers that could see Islamic banks further abandoning the practice. Islamic banking experience in mudarabah has not been good. However, the benefits of practicing two-tier mudarabah model outweigh its short-comings. Islamic banks should not overlook this factor and avoid reckless practice of deferred contracts. Shirkah contracts have always been practiced by Muslims; therefore present Islamic banks a suitable model to involve in financial intermediary function.

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