



# Analysis of Adoption of Mudarabah and Musharakah in Pakistan

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## ABSTRACT

Because of the Riba free and Profit Loss Sharing (PLS) features, the reputation of Islamic banks has highly impacted the banking sector. The banking has been popular in many Islamic nations such as UAE, Malaysia, Indonesia and Pakistan. Pakistan is being governed commercially by the conventional as well as Islamic banking system. These Islamic banks have been prone to vulnerability in their lack of ability to tackle loans-based interest and their tiny existence lacking expertise.' The questions which arise are whether there are any tools which benefit the Islamic banking sector. Yes, there are many products which provide interest-free banking to the folk in general so that the real essence of the law is being followed. The research paper focuses on the issue of conversion of Mudarabah (semi-partnership) into Musharakah (partnership) and whether the Standardization benefits Islamic banking in Pakistan will be discussed in the chapter. The paper goes into detail regarding 'the methods of preparing, adopting, and implementing as well as promulgation of laws in Pakistan in respect of these Standards.

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## INTRODUCTION

### Musharakah and Mudarabah

Mudarabah is a partnership contract in which the investment is offered by one person to another for investing the same in a business (Okumuş, 2024). It is a unique type of partnership which is introduced by Islam. The person who offers money is called Rab ul Mal while the person to whom the same is offered for business investment is called Mudarib. Capital for the business is exclusively provided by Rab ul Mal and the business is managed and controlled by Mudarib. As far as profits out of business are concerned, the same are

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divided according to a defined formula set between the two while losses are normally incurred by Rab ul Mal except in cases of negligence and misfeasance. Musharakah has been defined as a partnership which involves the sharing of profits according to a defined ratio and losses in equal proportions with all the parties providing capital as well as management and control over the enterprise. (Ratnawati & Sari, 2021) It is not a necessary condition in the partnership kind that all the partners shall take part in management yet it is enough that the partnership is managed by other partners. The distinguishing feature is the provision of capital in Mudarabah, capital is provided by one partner while in Musharakah, the capital is contributed by all partners.

### **Musharakah and Mudarabah Standards**

The Shariah Standards issued by the AAOIFI include Standards on Musharakah (El-Halaby et al., 2021) and Mudarabah and they have been used throughout Islamic banking for their services. As discussed in previous chapters, the AAOIFI has issued the Standards in the light of various Islamic legal teachings as well as the interpretations by various Islamic schools of legal thought. These two Standards have been analyzed in the following paragraphs.

### **The Scope of Mudarabah & Musharakah Standards**

‘Many Islamic scholars argue that finance and banking came into being as a result of providing an alternative to Riba. Islamic banking uses ‘equity-based systems for the division of losses and profits called’ Musharakah, Mudarabah and sale-based products such as Murabahah, as well as some kinds of Sukuk. El-Halaby et al., (2021) define a Mudarabah as a profit-based partnership where capital is contributed by one and labour by the latter, as described in the Standards. In a form of Islamic banking, one person is designated as an investor (Rab ul Mal) while the other manages the funds being invested in a skill-based business Mudarib while the profits are then distributed according to a predetermined ratio. For instance, the hired party (Mudarib), who contributes services or experience in exchange for compensation, may join the investor for the monetary losses (Abdul Rashid & Hassan, 2023).

Like Mudarabah, Musharakah takes the meaning of "sharing" which is one of the kinds of partnership where parties divide profits by a specified/agreed amount. Musharakah and Mudarabah are different from each other, though (Iqbal & Mirakhor, 2011) it provides investing persons with a synergy where they unite their earnings.’ There is a difference based on controlling the business in the joint pool. ‘Regardless of whether or not profits are made, all partners benefit from the increase in value of the assets, but in Mudarabah, commodities acquired by the Mudarib are entirely held by the Rab ul Mal, who can only receive his share dividends when they do business by getting profit for a product.’

### **Accounts of Mudarabah and Musharakah**

Based on a loan the conventional banks deal in all kinds of accounts, be they term deposits or saving, the default or for that matter interest-based accounts. They give free services based on the accumulation accounts. In addition, these banks prefer any kind of investment ignoring the principles of Islamic law through different means and generating funds therefrom (Ariff & Lewis, 2014). If the bank invests client funds in multiple enterprises, profits are divided between the bank's clients by an agreed amount of dividends/profits, but any loss is divided based on the invested funds' investment ratio. Terms Deposits and Savings Accounts are given based on Mudarabah (Shariah teachings). Musharakah and Mudarabah are the kinds of partnerships in which the losses as well as profits are divided equally with the risk percentage being high in each case. The due amount of compliance is paid towards the conditions which are necessary to bring the transactions by Islamic law principles.

### **Musharakah and Mudarabah Rules**

There are various rules by which Musharakah is being regulated:

It may occur between two parties through a deal or contract (or more). This agreement is designed to be a capital-sharing or profit-sharing structure. Before signing a contract, everyone must agree on a contribution and share ratio. All the partners must contribute to the development

of a business partnership to get a return on investment. The parties need to be wise, mature and legally able to enter and be obligated by agreements (Okumuş, 2024). The creation of a contract requires the voluntarily given permission of all parties before it can go into effect. Contracts shall not be based on fraudulent, misleading facts and contents (Usmani, 2008).

'Mudarabah is yet another tool of banking for providing and investing in financial transactions. It can rightly be stated that the banking hasn't made any considerable improvement in terms of its resources, even when they are allowed to do so by the law.' Mudarabah has most often been used interchangeably with PLS (Yustiardi et al., 2020). A Mudarabah does not need to contain a provision for losses and profits division. However, appropriate to describe the Musharakah contract to be a PLS setup. It would be more accurate to refer to the Mudarabah contract as a profit-sharing agreement. The individual who supplies capital is referred to as the owner of the capital and the person who manages the enterprise is called "agent" or "worker". They have been given certain responsibilities and functions according to Islam (Javaria, 2016). Resultantly Mudarabah can sometimes be called a sleeping arrangement. The income dividing system of Mudarabah can be stated to be a distinctive setup and the profits among the partners can be divided on any agreed arrangement.' All kinds of Mudarabah have been used for long. On an individual level, Mudarabah advances money and investment to other enterprises based on PLS. 'A current combined Mudarabah could be created in case the bank and an individual invest based on the setup while distinct accounts are maintained for the purpose until the completion of the last settlements. In most cases, investing through the tools function based on a joint Mudarabah (Warninda et al., 2019).

### **Diminishing Musharakah**

Diminishing Musharakah refers to a newly structured or variant form of Musharakah. Another term used for the Diminishing Musharakah is called "Mutanaqisah", or Musharakah which decreases in quantity. If the investors opt for liquidity over a long-term bank partnership, they can benefit from this transaction. Therefore, Musharakah reduces year by year in that the enterprises will return capital to investors. According to the notion of co-ownership lenders and their clients jointly own real estate, equipment and joint business ventures (Jais et al., 2020). As a result, diminishing Musharakah has appeared in various transactions in different ways. The same has been used in real estate and advancing loans for homes greatly. This decreases the financier stake from seventy per cent to eighty which is a significant reduction. (Jais et al., 2020) Resultantly, the price a person has to pay as rent decreases regarding the advance by the financier.

### **AAOIFI's Adoption of the Standards**

The standard of Mudarabah, which is detailed in the Shariah must be followed by IFIs acting as Mudaribs or investors. This standard covers the IFI to entity or individual Mudarabah contract transactions. It also covers the management of jointly created Mudarabah. It was adopted as a Standard in Medina in the year 2002. The standard of Musharakah sheds light on the basis as well as universal application of Sharikat-ul Aqad "contractual partnership", identified as Musharakah, with the ruling, vocation partnership and declining ones. Applicable laws and Shariah restrictions must all be considered by IFIs when describing these partnerships. It covers the traditional Fiqh-based shariah except for those who are expressly excluded by this standard. The same applies to all its kinds Mudarabah/Qirad creates a link amongst assets and enterprise. Through which partners would own the raised profits by contracts. Rab-ul-Mal supplies the capital, the Mudarib Amil or Muqarid is the investor and both get their shares from the profits (Usmani, 2008). The acceptance of this kind of setup in Islam has been established through the Quran, tradition and Fuqaha's rulings. The permissibility of Sharikah has been confirmed by God Almighty: {"... 'And, verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few'..." (Al Quran). Additionally, since the rise of Islam, partnerships have been among the most significant business deals in all nations. To put it another way, there is no consensus about the legitimacy of partnerships (Usmani, 2008).

### **Musharakah and Mudarabah: Comparison with Conventional Banking Products**

The supervisory system of Islamic banks has been different from others as they have been

managing their affairs through Shariah Boards. Due to their fewer product options and adherence to Shariah, Islamic banks have a greater asset quality than regular banks. According to studies, Islamic banks in Turkey have better asset quality than traditional competitors according to a review of 510 institutions from 22 different countries. Liquidity has a significant impact on Islamic banks' profitability. Due to non-Shariah-compliant banking practices and inadequate liquidity management, depositors are abandoning Islamic banks in large numbers. To operate securely, and maintain excellent customer connections; to avoid liquidity problems, banks need to control the supply and demand of cash. It has also been shown that Islamic banks are better able to manage liquidity (Beck et al., 2013). Islamic banking was established in Pakistan because of both religious and economic pressures. The most significant and effective attempts to eradicate Riba from the economy as a whole were made in the early 2000s. SBP accounting standards state that all banks in Pakistan adhere to their specifications.'

'Many non-Muslims are also consumers of IFIs. It has been found that the system is being operated in developed states such USA (Salman & Nawaz, 2018). Islamic banking, which first operated as a simple profit-sharing structure, is today flourishing because of the introduction of several instruments like Sukook to the market. The main products base their operation on dividing of profits such as Mudarabah, Musharakah, Ijarah, and interest-free loans (Murabahah). The system is different from the regular one as it is not based on interests. Like how the government and central bank supervise conventional banks, the SSB approves these instruments and oversees they are applied as set by the board. Several rules that are specific to Islamic banking are established by the central bank. As an illustration, the least that can be invested in these banks is in most cases exceeding limits prescribed by other banks. Intriguingly, other banks use payment-based profits which are made necessary by central regulatory bodies (Hanif, 2014). Interbank deposits are also rewarded with interest by commercial banks. IFIs have very few choices for producing liquidity and making money through investments in these sorts of bonds.'

### **Issues with Musharakah and Mudarabah Financing in Pakistan**

The situation in Pakistan is that the Musharakah financing has been relied on often while the Musharakah and Mudarabah are considered as the uncontroversial products of Islamic financing. The foremost reason for the same has been termed as the lack of any guidelines by SBP. Interest-free banking in Pakistan is in a nascent stage that's why the same has not been made possible over a short period. Although it has established the Islamic Banking Division in the field, the practice will take some time to mature. Another reason for the same is the absence of any interest by bank management. That is because the bank staff may be ignorant, ill-equipped with the rules or maybe deputed from conventional banks. The unavailability of any support from the Government in the legal field is yet another reason. The interest-based banking has been supported by Governments since the country's birth while the interest-free system has been exposed to many legal and moral hurdles in its success. Risk and loss, the lack of any mechanism of checks and balances and the accounting problems add to the plight in Pakistan which shows that the Musharakah and Mudarabah have been neglected over time (Rahman, 2018).

### **Influence of AAOIFI in Standardization on Banking Practices and Legislation in Pakistan**

In recent years, the IFIs have drawn the devotion of academics, clients, and regulators. Nevertheless, the conservative banking system continues to dominate in the modern world. To survive in the bi-setup system they need to race against the orthodox banks through Standardization, and modernization, both within and outside banking financing. Being the basic duties of Islamic banking, they are burdened to provide genuine as well as apparent commercial activities with no amount of Riba and ambiguity, besides, the system being based banning of Riba it has been adopted by states like the United Kingdom. Regarding combating the monetary arena, the system has been impeded by many obstacles in this regard (Mia et al., 2016).

The prevalent system of banking in Pakistan was held to be un-Islamic Shariah constitutional body (FSC) as it violated injunctions of Quran and Sunnah and allowed Riba... when contested in an appellate forum, the Supreme Court directed that all existing laws have interest-free teachings according to Islamic teachings. A panel was established and entrusted with the reform of these laws and, if necessary, offered methods for attaining the objectives. This was an order of unifying

and codifying laws to bring it by Shariah. Through the decision, the lives of all Muslims in the country needed to be served without the practice of Riba. Some banks opened their subsidiaries propagating and practicing Islamic laws of finance. According to the State Bank of Pakistan, there are a few kinds of Islamic Banking (IBs), "the fully Islamic Banks, such subsidiary of a mainstream bank and an independent Islamic Bank of a conventional bank". The part that SBP has played in the propagation and training of Islamic banking could not be ignored in the research regarding clientele, banks, as well as employees.' Some amendments in regulation by the SBP aim at making the process easy, and less sturdy and by the Shariah (Khan et al., 2020).

### **Implementation of the Standards**

Since it came into being in 1956, the SBP has been the authority behind the regulation of banking companies, both Islamic and conventional. Amongst the many first countries, Pakistan has adopted Islamic banking by issuing licenses to IFIs and regulating them with regulations. The State Bank of Pakistan oversees establishing the guidelines under which the banking industry would function according to these principles provided by AAOIFI in varying times. They have been promulgated by the teachings of the Quran and Sunnah. The central bank of Pakistan has played a vital role through cooperation internationally and imparting knowledge in the field." Different meetings with other countries by the Governors of the State Bank to accrue and share techniques and awareness regarding Islamic banking. 'A distinct wing of the State Bank of Pakistan is involved in publishing passivity information regularly for Shariah-compliant review. Furthermore, SBP is tasked with creating and thoroughly analyzing the practical information on the functioning of the institutions and the standard of submission of 'Shariah Standards' in their work (Akram, 2019).

### **CONCLUSION**

Shariah Standards of Musharakah and Mudarabah have been adopted by the AAOIFI keeping in view and going through the process of legal reasoning in this regard as against the tools used by other conventional banks in their operations. The paper attempts to answer research questions. It has been observed that the conversion of Musharakah into Mudarabah is allowed when carried out in light of the requirements mentioned above. In answer to the first question, it has been observed that the mixing of the profits of Mudarab with those of the business is not allowed. It must be kept in separate accounts, and it is the Mudarab who shall be responsible for the administration and working of business. The primary obligation of the State Bank of Pakistan is to guarantee the smooth and effective confirmation of these standards by the IFIs in the country. In this regard, various circulars have been issued by the Bank to serve the purposes. The Shariah boards, in this regard, have passed the test of time having an enormous impact on the implementation of these standards. Regarding the implementation of the standards, the Standards of Musharakah as well as Mudarabah and especially Diminishing Musharakah are being regulated by SBP for incorporating to give great benefits; the same has been achieved. The central authority in the state is the State Bank of Pakistan for overseeing, implementing and giving suggestions in this regard and has made the Internal Boards of the IFIs responsible for overseeing, revision and evaluating these standards.

Mudarabah and Musharakah are highly practised in Islamic banking in Pakistan, on the deposit side. Although it is being practiced a lot but proves to be challenging. In this situation, the bank which receives deposits has to further finance clients to keep the money flowing and being invested in a business, therefore, both sides of banks, that is, the spending deficit unit (SDU) surplus spending units (SSU) are important for the products. There appears to be a high risk in the spending of the resources, so the banks need to be encouraged and provided with guidelines to tackle the problem of being manhandled. There are other problems such as a lack of interest on the part of bank administration in the presentation of the Standards but the same can be overcome with the help of the central bank if it encourages them towards these products in the shape of some incentives. Other problems include the high level of risks involved as well as the lack of any mechanisms for the regulation of SSUs and SDUs. This and the problem that the customers are reluctant to use Musharakah and Mudarabah as modes of financing can be solved with the help of assurance of interest-free banking by the Central bank.

### **Recommendations**

Musharakah and Mudarabah, being Profit Loss Sharing setups provide alternatives to the prohibition of interest (Riba). These Islamic Financial tools are different than the conventional partnerships for the reasons stated supra. These Standards although issued by AAOIFI are the better alternatives however element of risk inherent in these products becomes an impediment for the banks to adopt these products on the financing side, thus there is a need for further research to develop better mechanisms to control the issues of risk in it. It is recommended that the implementation of Shariah Standards No. 12 and 13 must include conditions making the system of collaterals less sturdy and easy.

Through the various circulars of SBP, the Shariah Standards have been adopted by Islamic Banking Institutions in Pakistan but there is less awareness about the level of conforming to the Standards in their operations. The same can be achieved by promulgating legislation on a national level in this regard which will make the enforcement of the financial traits punishable if breached like penal provisions. In that very scenario, the adoption of the Standards shall be more uniform and widely acceptable.

## Competing Interests

The authors declared no competing interests.

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