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Issues and Challenges in Offering *Muḍārabah* and *Mushārakah* Products in Islamic Finance

(*Isu dan Cabaran Penawaran Produk Mudarabah dan Musyarakah dalam Kewangan Islam*)

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ABSTRACT

The study aims to explore the views of scholars, bankers and entrepreneurs in promoting muḍārabah and mushārakah based contracts and to analyse their views to strengthening those practises. The study utilized qualitative research approach which consists of document analysis, interviews and observations in few phases. The study found few industrial concerns such as the needs on checks and balances in muḍārabah and mushārakah to avoid failure; the lacking of some good qualities and hence certain conditions must be imposed on entrepreneurs if they want to conduct business based on mushārakah or muḍārabah contracts. In addition, although all respondents agreed that the ḍamān concept is actually contrary to the concept of muḍārabah (muqtaḍā al-'aqd), they still stress the need for a mechanism to make entrepreneurs serious in conducting the business. However, the disappointing conclusion derived from the interviews is that the industry is quite reluctant to enhance their participation in muḍārabah- and mushārakah-based products.

Keywords: Muḍārabah; mushārakah products; Islamic finance; daman; burden of proof

ABSTRAK

Kajian ini bertujuan untuk meninjau pandangan ulama, bank-bank dan usahawan dalam mempromosikan kontrak-kontrak yang berasaskan kepada mudarabah dan musyarakah, dan menganalisis pandangan mereka bagi mengukuhkan amalan tersebut. Kajian ini menggunakan pendekatan penyelidikan kualitatif yang terdiri daripada analisis dokumen, temu bual dan pemerhatian dalam beberapa fasa. Kajian mendapati terdapat kebimbangan industri dan industri menekankan keperluan "sekat dan imbang" dalam mudarabah dan musyarakah untuk mengelakkan kegagalan; pengenaan beberapa syarat mesti dikenakan terhadap usahawan yang tidak mempunyai beberapa kualiti yang baik apabila mereka ingin menjalankan perniagaan berdasarkan kontrak musyarakah atau mudarabah. Di samping itu, walaupun semua responden bersetuju bahawa konsep daman bertentangan dengan konsep mudarabah (muqtada al-'aqd), mereka menekankan perlunya satu mekanisme untuk memastikan usahawan serius dan berhati-hati apabila menjalankan perniagaan. Walau bagaimanapun, rumusan yang mengecewakan diperolehi daripada temu bual tersebut ialah industri agak keberatan untuk meningkatkan penyertaan mereka dalam produk berasaskan muḍārabah dan musyarakah.

Kata kunci: Muḍārabah; produk mushārakah; kewangan Islam; daman; beban bukti

INTRODUCTION

In the wake of the vast development of Islamic finance over the last few decades, much has been said about the limited track record of Islamic financial institutions (IFIs) applying risk sharing principles, especially *muḍārabah* and *mushārakah*. The data of Bank Negara Malaysia in 2016 shows that the combination of financing by concepts of Islamic banks amounted to the total of RM390 billion. The issues of high risk in general and multi-faceted business risks in particular that are associated with *muḍārabah* and *mushārakah* became the main obstacle in the implementation. To minimize these risks, scholars have prescribed proper guidelines such as on *taqṣīr* (negligence) and *ta'addī* (transgression). Discussion of the concepts of *taqṣīr*, *ta'addī* guarantee and the management of moral hazard in *muḍārabah* and *mushārakah* products are paramount in realizing their implementation.

PROBLEM STATEMENT

One major problem with the profit and loss sharing (PLS) contracts that has been frequently mentioned in the literature is the agency problem, which is said to be inherent to these types of contracts. For example, in the words of the State Bank of Pakistan 2008, "The agency problem is one of the major factors for the reluctance on the part of banks to undertake equity based modes of financing, as it gives entrepreneurs the incentive to under-state profits." (Kazarian 1993; Rickwood & Murinde 2002; Dār & Presley 2000; Iqbal & Molyneux 2005).

Ashraf and Lokmanul (2011), after noting the moral hazard of customers reporting loses in their financial statements in order to avoid paying the *rabb al-māl*, suggested that IFIs in *muḍārabah* and *mushārakah* arrangements may require customers to prove their integrity in order to protect the IFIs' position. Part of the due diligence process when applying for *muḍārabah* financing involves feasibility studies. Financing will not be approved unless the proposed project is determined to have a good probability of being profitable. The occurrence of loss raises the very real possibility that the customer was negligent. Hence, such customers have a responsibility to prove that they are not guilty.

However, this view seems to contradict the stance of Shariah from a few aspects. First, the Islamic legal maxim states: *al-aṣl barā'at al-dhimmah* (freedom from liability is the pre-existing and therefore prevailing state). Second, *muḍārabah* is a trust-based contract; the entrepreneur holds the capital provider's fund under the principle of trust. Requiring the entrepreneur to prove his innocence means that he is presumed guilty unless he provides evidence to the contrary, which may contradict the essence of the *muḍārabah* contract.

All of these highlight the needs to analyse the issues in detail in order to uphold the appropriate view related to the essence of both contracts and the limitation that a guarantee can be implemented in partnership contracts. In addition, comprehensive views from practitioners, scholars and entrepreneurs are very much needed to strengthen this practice and to understand the challenges in promoting these concepts.

OBJECTIVES

The objectives of this study are to explore the views of scholars, bankers, and entrepreneurs in promoting *muḍārabah* and *mushārakah* based contracts and to analyse their views in order to strengthen these practises.

LITERATURE REVIEW

Hassan and Mehmat (2008) said that *muḍārabah* contains many risks, particularly business risks. They insisted that managing a business has its own risks and that Islamic banks need to face these risks. Among other risks inherent to *muḍārabah* are the business partner's freedom to terminate the partnership at any time, which will definitely cause the business to be liquidated because no one can be forced to continue a partnership against his/her will. Given this reality, many Islamic banks avoid unnecessary exposure to *muḍārabah* risk. However, a few studies revealed that some anxieties, such as the withdrawal of investors, have been overcome by the existing structure of the *muḍārabah* contract. Based on the decisions of the Accounting and Auditing Organisation for Islamic Finance Institutions (AAOIFI) as stated in Shariah Standard 2010, Standard 13, Section 4, which affirms that the *muḍārabah* contract is not binding (*ghayr lāzim*) and that each contracting party is free to withdraw except in two situations:

1. The *muḍārib* has started the work; as soon as that happens the *muḍārabah* becomes binding until the occurrence of liquidation (*tanḍīḍ*), either actual (*ḥaqīqī*) or constructive (*ḥukmī*).
2. If the two sides have agreed to stipulate a term for the *muḍārabah*, it cannot be dissolved before the due date except with the consent of both parties.

If an Islamic bank enters into a partnership in which the managing partner cannot be held responsible for any operational losses, it means that the Islamic bank cannot collateralize the risk. Therefore the *muḍārabah* structure of equity finance becomes riskier for the Islamic banks. In fact, it is listed as the fifth risky type of financing in terms of credit risk (Khan & Ahmed 2001). Moreover, Islamic banks as financial intermediaries have to undertake the process of project evaluation, which is very long and costly. The expertise that is needed for the decision process is complicated.

Several authors have come up with a number of solutions in order to make PLS contracts more appealing to IFIs. Bacha (1997) proposed that the *muḍārib* must 'reimburse' the *rabb al-māl* in the event of certain outcomes. Karim (2000) recommended that the *muḍārib* contribute some capital or collateral in the project. Adnan and Muḥammad (in Obaidullah 2008) argued that while cases of *muḍārib* negligence leading to losses are taken care of in *muḍārabah*, proper systems should evolve to establish such negligence and ascribe the losses to the *muḍārib*. Khan (2003) suggested that banks guarantee investment deposits by *tabarru'* to minimize the agency problem.

A few papers were presented on this topic at the Fifth Regional Shariah Scholars Dialogue in Phuket, Thailand in 2011.[1] Ashraf and Lokmanul (2011) emphasized that the view of the majority of scholars prohibiting a guarantee in *muḍārabah* is the strongest opinion. However, they said that stipulating a guarantee in *muḍārabah* using the same basis as in the imposition of liability on artisans and on those offering their labor to the general public (*taḍmīn al-ṣunnā'* and *al-ajīr al-mushtarak*) seems acceptable in order to protect public interest (*maṣlaḥah 'āmmah*) against the loss of wealth, especially in a time when dishonesty has become typical behavior.

Reflecting on the view above, this study observes that the guarantee element in both issues, i.e., *taḍmīn al-ṣunnā'* and *al-ajīr al-mushtarak*, does not change the nature of either contract. Each is inclined to be categorized as *ḍamān al-yad* (liability due to possession) or *ḍamān al-mutlafāt* (indemnity for damage). Therefore, the guarantee should be allowed in both cases as no element of *qarḍ* and *ribā* appears in them. However, the case is different in a *muḍārabah* contract, as the

arrangement in *muḍārabah* is providing money against a portion of the profit. Therefore, any guarantee element shall transform the contract into a *qarḍ* contract. Hence, the guarantee element has changed the essential nature of *muḍārabah* (*muqtaḍā al-'aqd*). Therefore, any measures to protect the investors (*rabb al-māl*) should observe these matters. Steps in that direction are still possible as long as the efforts do not exceed the boundaries of *muḍārabah's* essential nature.

Ashraf and Lokmanul (2011: 16-17) then suggested that *muḍārabah* contracts with small and medium industries should be treated on the basis that they are liable for the capital in the event of loss, unless they are able to prove that they were free from any negligence or irregularities in the management of the capital. The authors then gave the justifications for this view and suggested maintaining the original rules of *muḍārabah* for strong companies.

This research is of the view that the nature (*muqtaḍā*) of *muḍārabah* has been changed to *ḍamān* when the losses are placed directly on the entrepreneur. Whenever the nature of *muḍārabah* has been shifted to a guarantee-based contract, the *rabb al-māl* is permitted to take collateral against any loss. In addition, the nature of *muḍārabah* becomes similar to *qarḍ*. Furthermore, the entrepreneurs then have to fight to prove their innocence.

Another issue that may arise is to whom they have to prove it. This needs to be proven in court, which consumes a lot of time and money. Assigning the *rabb al-māl* the right to determine wrongdoing is hardly likely to result in an objective and impartial judgment. Notwithstanding these complications, this research is interested in the idea of developing an instrument to enable the *rabb al-māl* to get compensation if entrepreneur negligence and misconduct do occur.

Adiwarman (2011) also emphasizes the element of security or collateral in *muḍārabah* financing as practiced by Islamic banks in Indonesia. In their implementations, the *muḍārabah* contract is maintained as a trust contract, but the financier (bank) is allowed to impose collateral against any customer negligence or misconduct.

This practice is supported by AAOIFI in Shariah Standard No. 13, Section 6, which allows the placement of such securities by stating:

> The capital provider is permitted to obtain guarantees from the muḍārib that are adequate and enforceable on condition that the capital provider will not enforce these guarantees except in cases of misconduct, negligence or breach of contract on the part of the muḍārib.

However, Adiwarman did not mention when the collateral will be used to claim compensation for clients and customers. Does the practice of the banks genuinely compensate the capital provider regarding the negligence or misconduct of the entrepreneur, or are there cases where they liquidate the collateral against losses not resulting from negligence and misconduct?

Furthermore, who will determine that the entrepreneurs have committed negligence and misconduct in their actions? Can the bank alone decide on the matter? If the bank is the only party that can determine whether entrepreneurs have committed negligence or misconduct, is it fair to customers to have their fates determined by the financiers? Who then will examine the moral hazard of the financier (*rabb al-māl*) determining customers' negligence?

THE PROBLEM OF CAPITAL AND *MUQTAḌĀ AL-'AQD*

Aznan and Zaharuddin (2011), like Ashraf and Lokmanul (2011), have chosen the majority view of scholars that does not allow the element of guarantee in trust-based contracts such as *muḍārabah* and *mushārakah*, except if there is an element of *ta'addī* and *taqṣīr*. However, the authors raised several other issues that could be classified as controversial.

Aznan and Zaharuddin (2011) cited the views of some contemporary scholars about the types of *ta'addī*; for example, Hussein and Abdul Hamid al-Ba'li proposed that if that *muḍārib* has done feasibility studies and the investment results differ from the projections of the study, the *muḍārib* should be considered to have committed negligence and misconduct in his operations. In addition, the case can be analogized with the case of *al-taghrīr bi al-fi'l* (deceiving by deeds). Here, as in Ashraf and Lokmanul (2011) view, it is the responsibility of the *muḍārib* to prove that the failure to achieve profitability as in the feasibility studies is not due to his negligence.

The view of Hussein Hamid and al-Ba'li places too much weight on the feasibility study as a criterion for honesty; equating honesty with profit and dishonesty with loss. Interviews with the entrepreneurs showed that the feasibility study is not a primary factor of success or a very reliable predictor of it. On the other hand, the view of Ashraf and Lokmanul (2011) may be more suitable to protect the capital owner. Aznan and Zaharuddin (2011) also appeared to agree with Hussein Hamid in allowing liability for *ta'addī* to cover submission of all the *muḍārabah* assets to the *rabb al-māl* even if the *muḍārabah* assets exceed the capital costs. This view is intended to prevent the *muḍārib* from committing *ta'addī* in situations in which the value of the assets rise during the course of the *muḍārabah* venture, which may motivate him to liquidate the *muḍārabah* assets, return the capital back to the *rabb al-māl*, and pocket the difference.

However, this view does not recognize the increased value of company properties as a profit that reflects the *muḍārib's* good management through smart purchasing strategies. Therefore, it is more preferable if both parties should share accordingly any amount above the capital amount. Furthermore, this view may not be feasible in *mushārakah* in which the IFI provides part of the working capital that is used to bear the operating costs. In this kind

of *mushārakah*, the determination of profit is settled after calculating the overall profit of the company's operations. In the event of *ta'addī*, the *mushārik* seems to be a guarantor and liable to repay the investment by surrendering all of the company's assets. It seems unfair to the *mushārik* when *mushārakah* puts profit-sharing as a major requirement.

Aznan and Zaharuddin (2011) stressed that some past scholars such as al-Shawkānī (1998) and Ibn Taymiyyah (2001) and recent scholars such as Ḥammād (2011) allow the stipulation of *ḍamān* upon the *muḍārib* or *mushārik*. This study humbly offers a contrasting view from that of Aznan and Zaharuddin (2011) in their interpretation of Ibn Taymiyyah's view, which they understand to support the permissibility of holding the *muḍārib* or the *mushārik* liable. The differing interpretations of Ibn Taymiyyah's (2001) statements will be discussed in detail in section 3.4.1 on the essential nature of *muḍārabah*.

Although Ḥammād (2011) also upheld the non-guarantee element in *muḍārabah*, he is inclined towards shifting the burden of proof in disputes over profit shortfalls to the entrepreneur (*muḍārib*), i.e., he would have to prove that he had not been negligent and had not engaged in misconduct.

Based on what was discussed, the weightier opinion, in my view, is the permissibility of stipulating liability (ḍamān) on fiduciaries (umanā'). It is valid and binding as long as the stipulation does not empty the trust contract [of its content] and strip it of its true nature (in Aznan & Zaharuddin 2011).

A few writers before Ḥammād (2011) explored *muḍārabah* and *mushārakah* contracts. For instance, Taqi Usmani (2005: 38-40) discussed in detail current Islamic finance practices, including *muḍārabah* and *mushārakah*. He called attention to the element of capital guarantee in *mushārakah mutanāqiṣah* as presenting a possible issue of Shariah non-compliance in the arrangement.

'Abd al-Muṭalib and Ḥamdān (2005) also explored *muḍārabah* and *mushārakah* contracts and related them to the practices of Islamic financial institutions. A few elements of his explanation may help in the present discussion. Al-Khuwaytir (1999) discussed *muḍārabah* in his book using the normal method of comparative *fiqh* study without any relation to Islamic finance. Perhaps this was because Islamic finance was still a relatively new phenomenon at that time. However, he did touch upon a few relevant issues related to this study, such as the nature of the *muḍārabah* contract, the capital contribution, negligence and misconduct, among others.

Al-Dabb (1998) explored *muḍārabah* within the scope of Islamic economics. He compared the view of the Shariah on *muḍārabah* with the existing law of his country, Jordan. He too elaborated a few issues relevant to this study. A number of studies have explored the issues of *ḍamān*, *taqṣīr* and *ta'addī* in some details. Māyisah Kamāl (2009) touched upon the issues of *tafrīṭ*, *ifrāṭ* and *ta'addī* and the consequence of those acts, including *ḍamān*.

Al-'Anzī (2009) wrote clearly and systematically about compensation conditions in contracts. He discussed *taqṣīr* and *ta'addī* as well as the ways to compensate for those acts. Al-Khafīf (1981) wrote a valuable book on *ḍamān* in Islamic jurisprudence. He differentiated between contracts whose nature is guarantee and situations where a partner is liable (*ḍāmin*) because of his acts without transforming the contract into a guarantee-based contract.

To conclude the literature review, based on the discussion above, there are certain issues that do not require further debate, such as:

1. Jurists' views on *muḍārabah* and *mushārakah;*
2. The evidence for the legality of *muḍārabah* and *mushārakah.*

However, a brief discussion of these topics is still relevant for maintaining an orderly presentation of the concept under discussion. After analyzing the works cited, it is very clear that a few topics require further discussion; for example:

1. Issues related to *muqtaḍā al-'aqd* in *muḍārabah* and *mushārakah*;
2. Types of actions that can be considered from an Islamic point of view as *taqṣīr* or *ta'addī*;
3. Elements of security and guarantee in *muḍārabah* and *mushārakah* that are permissible as long as they do not change the essence of *muḍārabah* and *mushārakah*;
4. The contention that placing the burden of proof on the *muḍārib* or *mushārik* does not transform the *muḍārabah* or *mushārakah* into a guarantee-based contract.

METHODOLOGY

This research applies qualitative research approaches, in which according to Marvasti (2004) "the qualitative research provides detailed description and analysis of the quality, or the substance, of the human experience".

In choosing the research method, the nature of the data required and the practical constraints of the study must be considered. The best method employed is that which meets the research objectives and answers the research questions (Darlington & Scott 2002). In order to find out the issues and challenges in offering *muḍārabah* and *mushārakah* products in Islamic finance by Islamic banks in Malaysia, this study employs qualitative research technique, specifically in the form of content analysis of literature and in-depth interviews.

In the first phase, the study collected data from libraries in the form of related books, journals and other publications, and from recognized Internet websites pertains to the issues related to the research objectives: inter alia, Islamic principles and concepts related to Islamic law, and standards and guidelines on finance and the banking industry. The researchers were also engaged

in various industry talks in order to further understand the subjects of the study.

In the second phase, the researchers had interviewed a few Shariah advisors to explore their views on the discussed matters. Effort was then made to determine which of their views are the most relevant and justifiable. According to Sosulski and Lawrence (2008), a population (Shariah advisors) is selected because they are considered good sources of information that will advance the study towards a reasonable goal. This method entails the researcher selecting relevant respondents based on his prior knowledge of the population in order to meet specific study objectives. The sample size is not a concern, as Robson (2002) noted that there is no set number of interviews needed for a flexible design study.

Face-to-face interviews were meant to seek and thoroughly discuss the practices and issues regarding the matter under discussion. The respondents were selected by using snowball and purposive sampling techniques (Silverman 2000; Neuman 2003). Every interview was conducted for approximately 90 minutes, and each was recorded and transcribed for analysis.

In addition, this study applies the method of ethnography interviewing in which ethnography focuses on what are the activities in order to understand the complex behavior without strategy that limits the inquiry. It is not necessarily a structured interview (Othman Lebar 2007: 95). The ethnographic interview method allows researchers to assist respondents towards the answer to suggest the reasons behind the practices, since ethnography interviewing includes conducting a series of friendly conversations where the interviewer to slowly introduce new elements to assist participants to respond to the questions. Hence this study has chosen a closed, fixed-response interview where all interviewees were asked the same type of questions and asked to choose answers from among the same set of alternatives (Othman Lebar 2007: 121).

This type of study has few features such as a strong emphasis on exploring, or it has a tendency to work primarily with "unstructured" data. It is also beneficial in investigating a small number of cases and can be used to analyse verbal descriptions and explanations. The researcher also observed the practices through informal conversation with bankers and Shariah officers.

To check the validity and the reliability of the questions, the researcher conducted pilot interviews with four experts to get their views on the content of the questionnaire. As a result, the questions were amended in accordance with the recommendations to ensure appropriateness and clarity.

EXPERT VIEWS ON IMPLEMENTATION OF *MUḌĀRABAH*- AND *MUSHARAKAH*-BASED PRODUCTS

This section highlights the views of industry players, practising Shariah scholars and entrepreneurs, which were elicited from interviews with a selected number of them. The section is divided into two parts: first, the views of players in the Islamic finance industry and entrepreneurs; and second, the views of a few Shariah scholars who have been appointed as Shariah committee members in a few Islamic banks, and the views of entrepreneurs on questions related to them.

The interviews were conducted in four Islamic banks; Maybank Islamic, Hong Leong Islamic Bank, Standard Chartered Saadiq Bank and Kuwait Finance House. However, to avoid any confidentiality issues, the participating banks were renamed as Bank A, Bank B, Bank C and Bank D, in no particular order. The respondents of the banks consist of high managerial posts which includes Head of Shariah and Vice Presidents of the banks. As for entrepreneurs, interviews were conducted with a few Bumiputera small and medium entrepreneurs.

For the second part of the study five scholars were interviewed in order to get in-depth views regarding these issues. They were Ashraf,[2] Hidayat,[3] Joni,[4] Sobri[5] and Azizi.[6] As the approach of this study is to avoid any discomfiture to the interviewees, their names have been changed to Respondent A, B, C, D and E without following the sequence of their names as mentioned above.

BANKERS' AND ENTREPRENEURS' VIEWS ON IMPLEMENTATION OF *MUḌĀRABAH*- AND *MUSHĀRAKAH*-BASED PRODUCTS

A couple of banks, i.e. Bank A and Bank B, are interested in implementing the *muḍārabah* and *mushārakah* concept in Islamic banking system. However, Bank C is seen to be careful in stating its stance though its view is very close to the views of Bank A and B. The reason given by the Bank C is the infrastructure of banks in Malaysia still depends on the conventional banking landscape. Therefore, Bank C suggested that the percentage of profit would need to be higher if the *muḍārabah* contract were to be implemented.

In contrast, the remaining bank, i.e. Bank D, explicitly informed that it has no interest in implementing the *muḍārabah* concept due to the issue of trustworthiness between the bank and its customers. The main reason given is that, in the event of loss, only the investor (the bank) will bear the loss. Therefore, the bank should ensure and strengthen the monitoring process carefully in *muḍārabah* to avoid losses, and the bank found that such monitoring is not an easy task.

On the other hand, entrepreneurs expressed their interest in implementation of *mushārakah* and *muḍārabah* concepts in the Malaysian banking system. However, they agreed that the integral issue in *muḍārabah* and *mushārakah* is trust. They agreed that the current entrepreneurs lack sufficient good qualities. Therefore, surprisingly, they support the imposition of particular conditions on entrepreneurs if they want to conduct business using *mushārakah* or *muḍārabah* contracts.

THE RISK-SHARING ELEMENT IN *MUḌĀRABAH*

On the issue of whether investors are ready to face risks, based on the *ḥadīth* of *al-kharāj bi al ḍamān* ("Benefit goes with liability"), Banks A and B responded that they were of the view that the concept of *ḍamān* (guarantee) in a *muḍārabah* contract would turn it into a conventional (*ribā*-based) contract.

Regarding determination of the profits, Bank A agreed that the rate of profit should be based on the initial agreement. Although it was seen as more favorable to the customer, the operating profit rate in the Islamic banking system must follow the policy of the Central Bank, which means it cannot be much different from other banks, including the conventional ones.

ḌAMĀN (GUARANTEE) CONCEPT IN *MUḌĀRABAH*

The banks differed in their views about using *ḍamān* (guarantee/collateral) for capital security in business activities. Bank D responded on this issue by saying that the *ḍamān* concept is actually contrary to the philosophy or the *muqtaḍā al-'aqd* of *muḍārabah*. Therefore, any imposition of liability on the entrepreneur in the *muḍārabah* contract transforms the contract to a debt-based contract, i.e., conventional financing.

Surprisingly, the entrepreneurs stressed that the entrepreneurs should be liable for the funds in order to ensure that they are serious in conducting the business. It seems that they uphold the concept of liability on the entrepreneurs and that it is integral in order to ensure entrepreneurs' prudence and commitment to the success of the business. In the meantime, they agreed that the concept of liability contradicts the essence of *muḍārabah* and *mushārakah*.

DAMĀN NEGATE RISK TO THE CAPITAL PROVIDER

Most of the banks were not in a mood to respond to this issue. However, Bank D was very emphatic in rejecting the rule of *ḍamān* in *muḍārabah*. The entrepreneurs were of the view that when they are being held liable they will take things seriously.

RISK MITIGATION

Bank A has a method to reduce the risk in *muḍārabah* and *mushārakah*. Although this bank has begun to offer *mushārakah mutanāqiṣah* over the last three years, it had a fairly consistent method to filter applications by investigating the developers' track record on business activities.

Similarly, Bank B has a method to assess and evaluate the company, and this process has become a standard for decision making. In addition it also has a dedicated team to assess any application, and this has become a key factor in making the bank successful in the few *muḍārabah* and *mushārakah* ventures that it has undertaken. According to the officers, the team conducts site visits and checks the prospective partner's track record. Moreover, this kind of project typically has guarantees from the government or from GLCs.

Bank D proposed a relatively proactive method to reduce the risk by creating subsidiaries to operate *muḍārabah* products for the bank. This method is likely to reduce the risk faced by the bank due to the high risk it poses.

Bank A found that the government already has a controlling mechanism for the collateral and securities issues to manage the risk in the *mushārakah mutanāqiṣah* such as the Housing Guarantee Scheme (SJPP). The bank will finance 100% of the home financing amount under the SJPP. Bank A also proposed giving a business's rebate to the borrower if they belong to the *zakāh*-recipient category of overburdened debtors (*ghārimīn*) by using *zakāh* money.

In terms of practice, Bank C has adopted hybrid products (*muḍārabah* + *mushārakah*) in which the customer is considered the *rabb al-māl* and gives money to the bank, and the customer bears responsibility for any losses.

In mitigating the risk, entrepreneurs suggested that the capital owner should do the evaluation process more frequently and that the entrepreneurs be required to disclose all activities on an ongoing basis. Besides that, it was proposed that the owner conduct periodic evaluation and a regular monitoring process.

In addition, they agreed that stipulations can be used to reduce risk; for example, prohibiting or restricting the entrepreneur from going out of the country for a long period for a holiday or any other reason, which may have a negative impact on the business.

TAQSIR (NEGLIGENCE) AND *TA'ADDĪ* (MISCONDUCT)

AAOIFI's Shariah Board has agreed that the capital provider may demand collateral against *taqṣīr* and *ta'addī* in *muḍārabah*. The Shariah experts agreed with this view. In line with that, the entrepreneurs also agreed and stressed that collateral is a must when dealing with a large amount of capital.

THE MEANING OF *TAQṢĪR*

Banks A and B concentrate on the implementation of *muḍārabah* in home financing, and they agreed to the view that *taqṣīr* refers to a situation where the partner is unable to complete the construction of the house as stated in the agreement and the construction is abandoned. In determining the role of feasibility studies, the entrepreneurs all disagreed with the suggestion that the failure to meet the expectation should be deemed negligence or misconduct. They felt the need to have a parameter on *taqṣīr* and *ta'addī* that identifies specific acts as either *taqṣīr* or *ta'addī*, and that this list can be used in court as a basis for judgment.

RISK AS A MAIN CONSTRAINT FOR THE BANK TO IMPLEMENT *MUḌĀRABAH* OR *MUSHĀRAKAH* CONTRACTS

All banks agreed that risk remains a major factor deterring the implementation of *muḍārabah*- and *mushārakah*-based product. Banks C and D stated that there is a very high degree of risk for such products. According to the International Islamic Financial Service Board (IFSB), the risk-weighted rate can rise to 400% for both types of contracts.

LEGAL BARRIERS IN MALAYSIA

There are a few constraints that the Islamic banking system is facing in term of legal barriers:

1. The infrastructure of banks in Malaysia is based on the conventional system.
2. Central banks worldwide are following BASEL, which presents particular difficulties for Islamic banks since its requirements are derived from the conventional system.
3. Trade-based transactions need thick legal documents, which may consist of 500 pages, to comply with all the Shariah requirements.

THE STAKEHOLDER BARRIER

The industry players mentioned a few barriers to implementing *muḍārabah*- and *mushārakah*-based products:

1. Investors prefer low-risk products; however, Islamic banks' *muḍārabah*-based products are very risky. Definitely they will opt to go to conventional banks.
2. The existing bank infrastructure in Malaysia is conventionally based. To implement the *muḍārabah* and *mushārakah* contracts, the banks will need some support from the government to enable this type of contract to be competitive with existing conventional loans.
3. The customer perspective whenever they come to the bank is to apply for a loan; they are not seeking to conduct a business with the bank through *muḍārabah* or *mushārakah*. Banks cannot be expected to provide products for which there is no demand.
4. In order to comply with Shariah and legal requirements, the Standard Operating Procedure (SOP) in *muḍārabah* is too overwhelmingly difficult to follow. So there must be a clear framework from the Central Bank, and the findings of academic research and industry experience must be used to come up with ideas and energy to prepare an action plan for implementation.

OTHER CONSTRAINTS

A few other constraints that banks face in implementing *muḍārabah*-based products are as follows:

1. High risk involved because the bank is only an inactive partner with no management role in the business.
2. The abovementioned difficulty has led banks to implement measures in the operating procedure of *muḍārabah* that render its *fiqh* characterisation ambiguous. For example, in Sudan, bank representatives are stationed in the factories and involved with business activities in order to monitor daily operation of the business.
3. Banks lack stringent evaluation policies to scrutinize the *mḍārib's* risk profile and other attributes to ensure that he would be a good potential partner.

INCENTIVES EXPECTED FROM GOVERNMENT

The banks offered a few suggestions in order to expedite the implementation of *muḍārabah*- and *mushārakah*-based products:

1. The government should help to implement the *muḍārabah* and *mushārakah* products by developing and approving new products in a more interesting way.
2. A few banks suggested that Islamic banks establish special entities to offer such products and that the Central Bank provide special incentives to promote such initiatives.
3. Other incentives should be considered for offering *muḍārabah*- and *mushārakah*-based products.

RESPONSES OF SHARIAH EXPERTS ON *MUḌĀRABAH*, *MUSHĀRAKAH* AND *TAQṢĪR* AND *TA'ADDĪ*

Five Shariah experts directly involved in the industry as Shariah advisors in Islamic banks were interviewed for this study on a few themes and their responses are in the following table:

TABLE 1. Responses of Shariah Scholars on few themes related to the *muḍārabah*- and *mushārakah* practices

Theme	Respondent	Response
The content of *muqtaḍā al-'aqd*	All scholars	It must consists all elements of contract.
Ḍamān al-muḍārib	All scholars	Disagreed. The basic structure of *muḍārabah* must be maintained; the capital provider has to bear the risk and share the profit with the entrepreneur, and the entrepreneur has to bear the risk of losing his effort.
	Few respondents	They stressed the importance of good intention in implementing this kind of contract and the need to avoid trying to change its essential nature.
Ḍamān al-mushārik (Guarantee by partners)	All scholars	Disagreed
Risk sharing	All scholars	The *ḥadīths al-kharāj bi ḍamān* (benefit goes with liability) and *al-ghunm bi al-ghurm* (liability accompanies gain) require that the capital providers should bear the risk to the capital; however, their responsibility should be accompanied with Standard Operating Procedures (SOP).
The issue of imposing *ḍamān* on the entrepreneur,	Majority	Disagreed
	One respondent	It does not contradict with the essence of *muḍārabah* if there is an urgent need in accord with *maṣlaṣah* and to avoid harm; however, he proposes that the contract be given a different name such as *muḍārabah bi al-ḍamān*, *hibah bi al-shurūṭ*, *bay' al-wafā'* and others.
Risk mitigation	All scholars	Stipulating certain conditions to mitigate the risk is permissible; however, it should not impose difficulties on any party. One way to mitigate risk is for the state to make laws or lay down regulations, which is permissible whenever there is public benefit (*maṣlaṣah*); or to have some other suitable alternative. The bank must investigate the background of the clients as to conform to the Standard Operating Procedures (SOP), which without it, it would be categorized as a type of commercial fraud.
Taqsir and *ta'addī*	All scholars	It is permissible to impose collateral against *taqṣīr* and *ta'addī in muḍārabah* and *mushārakah* as upheld by AAOIFI.
	Few scholars	The court is the appropriate party to resolve the issue of negligence and misconduct.
Failure to fulfil the expectation of the feasibility studies	All scholars	It is not a negligence (*taqsir*).
Requirement to disclose his position in order to defend himself against any accusation that he has committed negligence or misconduct.	Few of scholars	It is not prohibited in a trust contract to put the burden of proof on the entrepreneur. The court is the right party to determine negligence and misconduct.
	Few others	The responsibility to prove the fact is on the claimant, not on the accused party.
The need to the parameters on *taqṣīr* and *ta'addī*	All scholars	Agreed.
Acts classified as *Taqṣīr*	All scholars	1. Payment made without following the SOP. 2. Failure to check the received items; any defect in them after such failure is a proof of *taqṣīr*. 3. Carelessness in properly documenting the transactions. 4. Careless in managing the business by doing other than what he was supposed to do. 5. Making changes without proper planning and evidence. 6. Failure in observing legal requirements. 7. Depending on a non-licensed supplier. 8. Careless in management. 9. Making a bad loan by providing a credit sale to someone who is not entitled to it; or entering a deferred payment contract with a supplier on non-standard terms and conditions. 10. No contingency planning.

Theme	Respondent	Response
Misconduct or violation	All scholars	Any act that goes outside the guidelines of justice and equity as drafted by Islamic law to the point of creating harm, even if the acts do not contradict the terms agreed by both parties.
Acts of *Ta'addi*	All scholars	1. Breach of contract 2. Dishonesty in using funds 3. Ignoring the terms and conditions stipulated by investors 4. Fraud.

SUGGESTIONS

They suggested a few proposals for the Islamic finance industry as follows:

1. No guarantee of capital and profit should be given for *muḍārabah* and *mushārakah* financing against causes other than *taqsir* or *ta'addi*.
2. The guarantee should be meant to protect the capital in the event of *taqṣīr* or *ta'addī*.
3. The obligation to prove non-occurrence of *taqṣīr* and *ta'addī* should be derived from a binding promise (*wa'd mulzim*) on the part of the entrepreneur. Any failure to prove the fact may result in liquidation of the collateral by the bank.
4. An independent third party is the appropriate party to decide on the occurrence of negligence or misconduct.

ANALYSIS OF THE INTERVIEWS, FINDINGS AND CONCLUSION

The conclusions with regard to the complexity to *muḍārabah* and *mushārakah* in term of risk appetite, moral hazard problem and efforts to overcome moral hazard as discussed before, and in tandem with promoting the practices of *muḍārabah* and *mushārakah* concepts in Islamic banking industry, the following are some salient points derived from the above mentioned interviews.

THE NECESSITY OF CHECKS AND BALANCES IN *MUḌĀRABAH* AND *MUSHĀRAKAH* TO AVOID FAILURE

All respondents accepted the necessity of checks and balances. They also agreed that the current entrepreneurs are lacking in some good qualities and hence certain conditions must be imposed on them if they want to conduct business using *mushārakah* or *muḍārabah* contracts. Such conditions are needed to ensure their accountability in order to assure their satisfactory performance.

ḌAMĀN (GUARANTEE) CONCEPT IN *MUḌĀRABAH*

Although all respondents agreed that the *ḍamān* concept is actually contrary to the concept of *muḍārabah* (*muqtaḍā al-'aqd*), they still stress the need for a mechanism to make entrepreneurs serious in conducting the business. It seems that they uphold the concept of liability on the entrepreneurs and that it should be an integral part of the arrangement in order to ensure that entrepreneurs act prudently and are truly committed to the outcome of the business. Entrepreneurs themselves stressed that the businessmen cannot realistically be expected to perform their best without liability for the capital.

BURDEN OF PROOF ON THE ENTREPRENEURS IN *MUḌĀRABAH* OR ACTIVE PARTNER IN *MUSHĀRAKAH*

With regards to the need for checks and balances, they have no serious objection to the concept of imposing upon entrepreneurs the responsibility to disclose their activities. It is apparent to the authors that there is no prohibition to requiring the entrepreneur in a trust contract to prove lack of guilt and requiring him/her to provide proper disclosure of his/her business management as long as there is no element of *ribā* in such a contract.

FEASIBILITY STUDIES

All respondents disagreed with the proposal that failure to fulfil the expectations of a feasibility studies can be treated as evidence of negligence or misconduct. That is because the findings of feasibility studies are relatively subjective. Furthermore, it is normal in business for results to differ from projections due to unexpected factors. They suggested that the court is the proper party to determine negligence and misconduct.

NO REASON TO STRENGTHEN *MUḌĀRABAH* AND *MUSHĀRAKAH* PRODUCTS

The most regrettable and painful result of the interviews is that the industry is quite reluctant to enhance their participation in *muḍārabah*- and *mushārakah*-based products. It is due to a number of reasons such as the trustworthiness issue between the bank and its customers. This issue remains a major challenge for regulators in determining their policies regarding the application of both contracts.

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END NOTES

[1] The study was a commissioned research by International Shariah Research Academy to the authors and meant to discuss few previous studies done by few writers. Therefore, it concentrated to those studies.

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