

Contract of Partnership

- It represents equity financing aspect of Islamic Financial Institution
- The main idea behind the establishment of Islamic banking
- *Mudaraba* and *Musharaka*
- Two Tier *Mudaraba*: Bank providing the entrepreneurship and capital at the same time.

Salient Features of Equity Financing

- Sharing in profit and loss
- No predetermined amount of return
- Partner relationship, not debtor-creditor relationship

Mudaraba Contract

- Definition: Profit and loss sharing in which one party provides capital, and the other work and management
- *Mudarib*: The entrepreneur (the effort side)
- *Rabb al-Mal / Sahib al-Mal*: Provider of Capital

Legitimacy

- The Qur'an
- The Sunnah
- The Practice of Muslim Society
- Affirmation of a pre-Islamic practice.

Types of Mudaraba

- *Mudaraba Mutlaqa* (unrestricted)
- No restriction on type, place, and time of business.
- It is up to the discretion of the entrepreneur to run the business according to his expertise and experience.
- Needs major degree of confidence and trust
- Lower position of capital

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- *Mudaraba Muqayyada* (Restricted)
- To impose some terms and conditions in the business.
- Violation of the terms would subject the entrepreneur liable for the loss.
- Needs less degree of confidence

Main Principles of *Mudaraba*

- Capital must be in monetary form. Other asset is acceptable, if it is valued at the beginning of the contract.
- Profit is shared according to ratio agreed upon. A fixed amount is not allowed.
- The loss is borne by the provider of the capital.
- The capital provider cannot intervene day-to-day business operation.

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- *Sub-mudaraba* is not allowed without the permission of the first capital provider.
- *Mudarib* cannot claim any periodical salary or a fee or remuneration for the business.
- Exceptions: (1) for daily food expenses (Ahmad); (2) for overseas travel (Hanafis) – overhead expenses?

Application in Islamic Banking and Financing

- Applicable in all investment accounts, i.e. general and special investment account (Deposit side)
- Financing side: for single transaction such as day-to-day needs of small traders, or single export or import activity.
- Long term investment, such as building an airport, real estates, high way, etc.

Modern Issue on Mudaraba

- Moral hazard
- Collateral ?
- Bankers are not trained in project financing
- Is *Mudaraba* Banking an alternative to the *ribawi* banking?
- BIMB Mudarabah Financing

Musharaka

- Definition: Profit and loss sharing in which both parties contribute capital and entrepreneurship together.
- The liability of the partners is normally unlimited.
- All the assets are jointly owned.

Main Rules and Principles

- It is a profit and loss sharing partnership
- Profit is shared according to the ratio agreed upon.
- Loss is divided according to the contribution of each party.
- One or both parties can withdraw from entrepreneurship and management. So, they will employ a *mudarib* or an employee to run the business.

Modern Application of Musharaka

- Direct *Musharaka*
 - Two persons can invest in one project
 - Management can be by both or one of them, or even by hiring another managing director, or by a manager under the contract of *mudaraba*
 - Ordinary stock tradable in the stock market

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- *Musharaka Mutanaqisa* (Diminishing Partnership)
 - One of the partners to progressively own the whole shares at the end of the day.
 - Example: A owns 10% shares and B 90%. They buy a house to be leased out to A. The rental payment will be distributed according to agreement. In the meantime A keeps increasing his share by buying the share of B, until A owns the total share; thus the house.

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Practice of Sudanese Islamic Bank which provides the farmers with ploughs, tractors, pumps, sprayers, and working capital such as fuel, seeds, pesticides, fertilizers. The farmers provide land, labour and management.

Muzara'a

- Partnership in Farming whereby one party provides the land and the other provides work and management.
- The rule of *muzara'a* is similar to *mudaraba*.
- Suitable for agricultural country

Musaqa

- Partnership in fruit-trees.
- It is a profit and loss sharing between the owner of the fruit trees and the cultivator who provides irrigation and maintenance of the trees.
- The rule of *mudaraba* also applies here.