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The *Muḍāraba* Facility: Evolution, Stasis and Contemporary Revival

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Abstract

The age-old concept of partnership was seen by Muslim jurists from the 8th century Hijra onwards as a sacrosanct commercial arrangement – and, therefore, subjected to a form of fixity which is unparalleled in any other religious tradition. Since the formative period of Islamic law, the limited-liability partnership, or *muḍāraba*, a specific variation of the over-arching *mushāraka* partnership, has continued to hold central importance for Muslims. Yet, despite this centrality, it has not been examined with a view to reformulating it for contemporary Islamic banking and finance. This has led to its virtual neglect in modern Islamic banking operations. This article suggests that the revival of the *muḍāraba* facility requires the overcoming of key disadvantages inherent in its structure and that a restructuring on the basis of the hybrid facility called participating preferred *ijāra* is one possible way of achieving such an outcome.

Keywords

muḍāraba, mushāraka, sunna, rabb al-māl, participating preferred ijāra

1 Introduction

Since their appearance in the 1970s, Islamic financial institutions (IFI) have been fixated, at least theoretically, on financial transactions which are designed to conform to the profit-loss sharing mode (PLS). The reason for this is two-fold: firstly, they are determined to adhere to the view of Muslim orthodoxy, which holds that interest is akin to the prohibited *ribā* and therefore is absolutely prohibited;¹ secondly, they seek to differentiate themselves from their conventional counterparts as “Islamic”.² Furthermore, Farooq describes IFIs as having idealised the PLS mode because of their determination to avoid debt-financing and use partnership and equity-financing, similar to venture

1 Hamid Harasani, “Analysing the Islamic Prohibition on *Ribā*: A Prohibition on Substance or Form?”, *Arab Law Quarterly* 27 (2013): 289–296; Muhammad M. Iqbal, “Prohibition of Interest and Economic Rationality”, *Arab Law Quarterly* 24 (2010): 293–308.

2 Mohammad O. Farooq, “Partnership, Equity-Financing and Islamic Finance: Whither Profit-Loss Sharing?”, *Review of Islamic Economics* 11 (2007): 68.

capitalism.³ This idealisation has its roots in classical Muslim jurisprudence, which gave centrality to two principal modes of PLS contract practiced by pre-Islamic Arabs and the early Muslims: *shirka/mushāraka* (partnership) and *muḍāraba* (limited liability partnership). According to Taqi Usmani, the globally renowned Ḥanafī scholar and pioneer of Islamic Banking in Pakistan, these are the “real and ideal instruments of financing in Sharī‘ah”.⁴ Paradoxically, while the pertinent literature in the Islamic Banking and Finance (IBF) movement continues to emphasise PLS as the main financial mode (and simultaneously continues to idealise *mushāraka* and *muḍāraba*), in practice IFIs have deliberately and systematically avoided them, as Farooq has shown.⁵ This is unsurprising since the parameters for the PLS modes in classical Islamic law are not well-thought out and therefore have little appeal to investors/lenders. This article will highlight the aforementioned parameters with specific regard to the *muḍāraba* facility and suggest ways of restructuring it based on Islamic legal theory. It is hoped that the outcome will imply that the modified forms of PLS financing can once again take their place as central in IBF.

Consistent with the study of Usmani,⁶ this article is divided into two parts: the first part undertakes a historical evaluation of *mushāraka*, which is a useful preamble to understanding *muḍāraba*, a subsidiary financial arrangement. Thereafter, we commence with a study of *muḍāraba* as a central financial instrument in the history of Islamic commercial law. Here we discuss the historical precedent of this financial instrument along with how the gradual onset of rigidity in Islamic legal reasoning might have been a central factor in jeopardising the underlying real economy in the Muslim world. The final section elaborates on one of the ways to revive the economy of the Muslim world – the adaptation of the *muḍāraba* facility to a hybrid form.

2 *Mushāraka*

Mushāraka (*sharika*, partnership) was a pre-Islamic organisational form of contract which by the 3rd century Hijra (9th century CE) became Islamicised through its integration into the *fiqh* literature. In essence, it allowed the pooling of resources of economic agents in the form of cash, goods, skills, or a combination of the same,⁷ and was akin to a private equity firm in the context of conventional finance. The term *sharika* is generally employed in Islamic jurisprudential literature more so than the term *mushāraka*, the latter being a neologism recently introduced in the area of Islamic finance.⁸ Since *mushāraka* constitutes an equity contract, its payoffs are based on profit and loss sharing. This is in contrast to rigid debt contracts, *i.e.*, *ribawī* contracts, which are prohibited in Islam.

3 *Ibid.*

4 Taqi Usmani, *An Introduction to Islamic Finance* (The Hague: Kluwer Law International, 2002).

5 *Supra* note 2.

6 See Muhammad Taqi Usmani, “The Concept of *Musharakah* and Its Application as an Islamic Method of Financing”, *Arab Law Quarterly* 14 (1999): 203–220.

7 Abraham L. Udovitch, “Partnership in Medieval Islamic Law”, PhD Dissertation, (Yale University, 1965).

8 *Supra* note 6 at 205.

In the era of the Prophet (PBUH), and for several generations after his death (considered the golden-age of Islam, including the period of the Rightly-Guided Caliphs and the Successors), Arab society was commercially savvy, apparently employing several forms of *mushāraka* structures, as described in the *fiqh* literature:

- (1) Partnership in ownership (*shirkat al-milk*), a basic form of partnership ensuing when two or more individuals jointly own a particular asset without a commercial aim. This joint ownership may take place at their discretion. For example, if two persons jointly buy a car, their relationship is termed as *shirkat al-milk*. In other cases, the joint ownership may compulsorily ensue without any action taken by either parties, for example, if two persons inherit a property jointly, they take ownership automatically.
- (2) Partnership by contract (*shirkat al-‘aqd*) is a form of partnership undertaken by two or more persons for commercial purposes. This form of partnership can be further categorised into:
 - (i) *Shirkat al-amwāl*, where two or more persons contribute capital in a commercial enterprise;
 - (ii) Labour partnership (*shirkat al-‘abdān*), where two or more persons undertake to deliver some services to their customers and share the income generated;
 - (iii) Credit partnership (*shirkat al-wujūh*), where the partners provide neither capital nor labour to invest; they buy goods or services on credit for the purpose of selling them and distributing the profit in accordance with the ratio of individual liabilities;⁹ and
 - (iv) Silent partnership (*muḍāraba*), where one party (the silent partner) provides funding while the other party (entrepreneur) provides labour. Profits are distributed in accordance with an agreed-upon ratio, where: (1) all monetary losses are borne by the silent partner; while (2) the entrepreneur loses his labour and time.

It is unusual that the *mushāraka* facility should have acquired a quasi-divine status given that simple partnership forms were not an Islamic innovation, but rather existed in Arabia in the pre-Islamic era.¹⁰ In fact, we know from historical sources that partnerships were known and practiced in the Near East at least since the Babylonians, and they were discussed in the Talmud and in the *Corpus Juris Civilis* of Justinian.¹¹ Yet Muslims are generally nostalgic about the *mushāraka* facility. Clearly it played an important role in the economy in early Islamic history, but this cannot account for the post-formative and contemporary fetish. The most plausible explanation is the attitude toward *mushāraka* expressed by Muslim jurists. For example, the 13th century Ḥanafī

9 Mahmoud El-Gamal, *Islamic Finance: Law, Economics, and Practice* (New York: Cambridge University Press, 2006).

10 *Supra* note 7 at 7–8.

11 *Ibid.*

jurist, al-Maḥmūd b. Mawdūd al-Mūṣilī (d. 1284), who cites in his commentary the following Prophetic traditions:

The hand of God is above two partners so long as none of them betrays his partner; if one of them betrays his partner, [God] withdraws His hand; God is the third in a partnership of two as long as they do not betray one another; if they betray one another, the grace is erased.¹²

He also presents the Prophet's involvement in a partnership with Qays b. Sā'ib as a normative act, following which he proclaims,

The Prophet was sent at a time when people engaged in partnerships; he did not censure them from engaging in this arrangement and so it has been employed until our day. That there exists no censurer indicates the community's consensus.¹³

It is unclear whether the consensus al-Mūṣilī invokes relates to mere permission to engage in a partnership based on customary practice or whether it relates to some sort of divine sanction. It seems that Muslims understood it to be the latter, since there is an extensive literature ensuing from both classical and contemporary jurists on the merits of *mushāraka* contracts.

A question discussed in the modern Western literature is whether the exposition of *mushāraka* in the *fiqh* literature is sufficient proof that the instrument was practically employed by Muslims. For some decades the dominant view among Western scholars of Islamic Law has been that the *fiqh* had very little to do with actual practice. *Fiqh* was considered by these scholars to be only of theoretical significance, and was developed by the jurists according to a paradigm which they considered represented the golden age of Islam. According to these scholars, to assume that the *fiqh* literature reflected the institutions and practice in classical Muslim societies is perilous. Yet we have started to see a more nuanced approach to this subject, with Udovitch among those advancing a different hypothesis on the question of theory and practice. Udovitch has highlighted that:

While recognising the ideal character of Islamic law, one cannot state a priori that any given institution had no relationship whatsoever to practice. This is especially so in the area of *fiqh* termed *mu'āmalāt*. Most of the material covered by these laws, for example, the contracts of partnership and *commenda*, does not involve any religious or moral principle. No religious or ethical value is attached to them. In the earliest legal texts especially, there is no reason not to consider them as a reflection and partial description of the institutions as they existed at that time.¹⁴

Furthermore, according to Udovitch:

12 Al-Maḥmūd b. Mawdūd al-Mūṣilī, *Al-Ikhtiyār li-ta'īl al-mukhtār* (Beirut: Dār al-Arḡam bin Abī al-Arḡam, reprinted in 1999).

13 *Ibid.*, p. 19.

14 *Supra* note 7.

The chapters on partnership and *commenda* contain numerous instances in which systematic legal reasoning is suspended because of the ‘custom of the merchants’ or ‘because of the needs of the merchants.’ Other applications of juristic preference (*istihsān*), although not coupled with these phrases, reveal a clear tendency toward allowing a greater freedom of trade practice. In the later legal treatises, this leniency, which often provides valuable indications of actual practice, is replaced by imitation and rigidity.¹⁵

It has been highlighted above that *mushāraka* became enshrined within the Islamic legal literature as a result of a broader process of islamisation which integrated within the Islamic legal system many cultural and customary practices that were prevalent at the birth of Islam. Furthermore, the fact that classical Muslim jurists were, in some ways, jacks of all trades, they perpetuated the idea that *mushāraka* was divinely ordained in their legal compendia. Kuran says:

For at least a half-millennium after the birth of Islam, then, Islamic partnership law was adopted by peoples located in far corners of the world as the institutional basis for commercial cooperation [...] Islamic partnership law presented limitations even by medieval standards. Most of its variants required a partnership’s principal to consist of currency; they prohibited investing merchandise directly, ostensibly to prevent unjust enrichment, more plausibly to forestall conflicts over the value of the initial investment and the division of profits. Moreover, the merchant’s mission was incomplete until he reconverted all merchandise bought on behalf of the partnership into the selected currency. When these rules were followed, they could drive partners to sell merchandise, or trade currencies, at an inopportune time or place.¹⁶

Kuran is bemused as to why modern Islamists want to restructure economies according to such rules:

In truth, by modern standards Islamic partnerships are very simple organizations. They are meant to support ventures of finite duration, not to open-ended ventures without an expected settlement date. They are poorly suited to projects requiring a huge sunk investment and delivering returns over many years. Because they lack legal personhood, before the law their members deal with third parties as individuals, rather than employees of a firm.¹⁷

Despite the extensive efforts of the scholars, the onset of modernity has handicapped them. This is because the venturing of traditionally trained jurists into spheres of human life which demand technical knowledge has implications

15 *Ibid.*, p. 13.

16 Timur Kuran, *The Long Divergence. How Islamic Law Held Back The Middle East* (Princeton: Princeton University Press, 2011), 60.

17 *Ibid.*

on the development of Muslim societies. The economic decay of the Muslim world is described by Schacht as follows:

Islamic law, which until the early 'Abbāsīd period had been adaptable and growing, from then onwards became increasingly rigid and set in its final mould It was not all together immutable, but the changes which did take place were concerned more with legal theory and the systemic superstructure than with positive law Taken as a whole, however, Islamic law reflects and fits the social and economic conditions of the early 'Abbāsīd period, but has become more and more out of touch with later developments of state and society.¹⁸

To elaborate the above further, we state that the *mushāraka* form has failed to evolve from the rudimentary stage of its inception in the medieval era to a form such as the corporate one which endows it the following comparative advantages: (i) limited liability; (ii) unlimited life; (iii) ease of transferability (liquidity) of shares (ensuing from a secondary market); and centralized management.¹⁹ Undoubtedly, this has had a corollary effect in the subsidiary form, known as *muḍāraba*.

Following this overview of *mushāraka*, the over-arching partnership form in Islamic jurisprudence, our discussion can now move to *muḍāraba*.

3 *Muḍāraba*

Muḍāraba is a limited liability contract between a principal (*ṣāhib al-māl* or *rabb al-māl*) and an agent (*muḍārib*), which constitutes a partnership of capital and entrepreneurship. The principal advances funds to an agent to be employed in a particular project, in return for a share in the profit (in a mutually pre-agreed ratio). The losses, if incurred, are borne only by the principal. This financial arrangement is a specific form of partnership (*shirka* or *mushāraka*), where capital owners (unable to participate in a trade) team up with those who have the necessary business skills (but are deficient in capital). This financial arrangement was known and practised in the Near East as early as the Babylonians,²⁰ known and discussed in the Talmud and later Rabbinical literature,²¹ and its various forms were practiced by Meccan merchants preceding Islam,²² which explains its employment in early Islam.

18 Joseph Schacht, "Pre-Islamic Background and Early Development of Jurisprudence: The Schools of Law and Later Developments of Jurisprudence", in Majid Khadduri and Herbert J. Liebesny (Eds.), *Law in the Middle East*, Vol. 1 (Washington, DC: Middle East Institute, 1955), 76–77.

19 See Andrew Winton, "Limitation of Liability and the Ownership Structure of the Firm", *Journal of Finance* 48 (1993): 487–512; Timur Kuran, "The Logic of Financial Westernization in the Middle East", *Journal of Economic Behavior and Organization* 56 (2005): 593–615.

20 *Supra* note 7.

21 See Bernard Jackson, *Jewish Law in Legal History and the Modern World* (Leiden: Brill, 1980).

22 *Supra* note 7.

Muḍāraba is a derivative of the Arabic infinitive, *ḍarb* (travel), as in the expression *ḍarb fī l-arḍ*, “to travel the land”. It is called *muḍāraba* because the agent earns his percentage of a venture’s profits as a consequence of the effort and labour he expends.²³ The term *muḍāraba* is of Iraqi origin, and was the preferred term of Ḥanafī jurists to describe this particular form of arrangement because of its close semantic connection with the Qur’ānic verse, “... And others travelling (*yaḍribūna*) through the land (for the purposes of trade)”.^{24,25} Jurists of the Mālikī and Shāfi‘ī Schools of Law refer to this contract as *muqāraḍa* (lit. “to surrender the profits”).

According to the 11th century Ḥanafī jurist, al-Sarakhsī, the legality of this form of contract is known via the normative practice of the Prophet (*sunna*) and the consensus of the early Muslims (*ijmā*). He cites several traditions in support of *muḍāraba*, the first two of which are given here: The practice of ‘Abbās ibn ‘Abd al-Muṭṭalib when he engaged in a *muḍāraba* arrangement was to stipulate in the contract that the agent (*muḍārib*) should not travel overseas or descend on a valley. If the agent failed to comply with this stipulation, ‘Abbās would demand compensation in the event of a loss. The news of this reached the Prophet, who deemed it acceptable. Another tradition tells of the two sons of ‘Umar, ‘Abd Allāh and ‘Ubayd Allāh, who once came to stay with Abū Mūsā in Iraq. After lamenting the fact that he did not have any savings from which he could support the two men, he offered them instead some money from the treasury (*bayt al-māl*). He advised them to trade with the money and then, on their return to Medina, return the capital to the Leader of the Faithful (*amīr al-mu’minīn*) and retain the profits for themselves. When ‘Umar heard of the arrangement, he protested that the capital was from the public treasury and so any profits generated from it should be returned to the public fund. It was only after some companions advised ‘Umar to consider his two sons as agents (*muḍārib*), whereby they were to take half of the profits and the other half is returned to the treasury, that ‘Umar was willing to acquiesce.²⁶ The remaining evidences which al-Sarakhsī furnishes in support of *muḍāraba* are of a similar ilk to these aforementioned traditions. Interestingly, in common with other jurists of the classical period, al-Sarakhsī made no attempt to provide a rational justification for this form of contract.

Muḍāraba was probably employed because it (i) circumvented the problem of *ribā* and (ii) allowed the investor to overcome the problem of having to precisely fix a wage in an arrangement which was essentially the provision of capital in exchange for labour. These advantages would have been factors which led the Prophet Muhammad (PBUH) himself and his eminent companions to employ this facility in trade, either as a *muḍārib* or as a *rabb al-māl*.²⁷ Yet there remained the inherent inefficiency associated with this arrangement, since the *rabb al-māl* was required to provide 100% of the capital, whilst at the same time

23 Shams al-Dīn Abū Muḥammad al-Sarakhsī (d. 945), *Kitāb al-Mabsūṭ* (Beirut: Dār al-Fikr, 2000), 17.

24 See Q73:20.

25 *Supra* note 23.

26 *Ibid.*

27 See Monzer Kahf and Tariqullah Khan, “Principles of Islamic Financing: A Survey”, Research Paper No. 16, Islamic Research and Training Institute, Islamic Development Bank, Jeddah, Saudi Arabia (1992); M. Nejatullah Siddiqi, *Partnership and Profit Sharing in Islamic Law* (Leicester: The Islamic Foundation, 1985).

being the sole bearer of losses. This naturally created an incentive (agency) issue, as the *muḍārib* had none of his capital at stake.²⁸ Another form of inefficiency was the denial of any form of control rights to the *rabb al-māl*. Both of these problems explain why the *rabb al-māl* tended to stipulate certain restrictions on the *muḍārib*, as can be seen in the above case of ʿAbbās, uncle of the Prophet, and in the long-term almost certainly led to the decline in the employment of *muḍārabah* as an instrument of financial intermediation.

Despite its disadvantages, the Muslim schools of law generally endorsed the application of *muḍārabah* in commerce, with Ḥanafī jurists taking a more liberal stance in contrast to the more conservative Shāfiʿī, Mālikī and Ḥanbalī jurists, who advocated its employment only in trade, where hired labour was not feasible.²⁹ For the latter schools, as explained by Hasanuz-Zaman,³⁰ *muḍārabah* defied both the general law of hire as well as ran afoul of several Ḥadīths – ‘Profit goes with liability’ (*al-kharāj bi-ḍ-ḍamān*) and ‘... (no) profits without liability’ (... *lā ribḥ mā lā yuḍman*) both of which form the basis of the well-known legal maxim ‘profits are concomitant to risk’ (*al-ghunum bi-l-ghurum*) – since the working partner is entitled to profits without having to bear any risk. As for its defiance of the general laws of hire, Hasanuz-Zaman elaborates:

Muḍārabah is a relationship between capital and labour in which the former utilizes the services and skill of the latter in return for a share in expected profits. Thus, it is essentially a contract of hire/ wage. But according to the basic rules of the Sharīʿah based on the Prophet's saying, a contract of hire/wage should precisely lay down the amount of hire/wage to be paid to the worker, failing which the contract becomes voidable and therefore the worker will have to be paid standard wage (*ajr al-miṭl*). In a contract of *muḍārabah*, on the other hand, the condition of precise fixation of wage to the worker does not exist. Thus the analogy of the law of wage demands that *muḍārabah* should be held unlawful. But the holy Prophet, in supersession of this rule, exempted this contract from the purview of the law of hire.³¹

The rather more liberal approach of the Ḥanafīs is the view promoted by the *Jamāt-e-Islāmī*, a political Islamist group of the Indo-Pak subcontinent.³² Its employment in the Islamic financial intermediation as a double *muḍārabah* is advanced by Uzair.³³ In the first tier, the Islamic bank acts as a *muḍārib*, while the depositors serve as the *rabb al-māl*. In the second tier, the bank serves as a *rabb-al-māl*, thereby trusting an entrepreneur to conduct his/her business venture. Profits, if any, are shared between them, and then between the bank

28 On this, see Humayon A. Dar and John R. Presley “Lack of Profit-Loss Sharing in Islamic Banking: Management and Control Imbalances”, *International Journal of Islamic Financial Services* 2 (2000): 3–18.

29 See Syed M. Hasanuz-Zaman, “*Muḍārabah* in non-trade operations”, *Journal of King Abdul Aziz University: Islamic Economics* 2 (1990): 69–88.

30 *Ibid.*, p. 81.

31 *Ibid.* p. 70.

32 See Siddiqi, *Partnership and Profit Sharing*; M. Umar Chapra, “Why has Islam prohibited interest? Rationale behind the prohibition of interest”, in A.S. Thomas (Ed.), *Interest in Islamic Economics: Understanding Ribā* (London, New York: Routledge, 2006).

33 Mohammed Uzair, *Interest-Free Banking* (Karachi: Royal Book Company, 1978).

and depositor. This structure is *not* observed in practice and is contested by the Traditionalist jurists (along with some Ḥanafīs), as elaborated below.

4 *Muḍāraba* and the Economic Decline of the Muslim World

Çizakça illustrates how the *muḍāraba* was adapted by the Italian merchants (trading with their Arab counterparts) in the form of partnership termed as '*commendā*'.³⁴ Further adaption of this facility is said to have climaxed in the form of a convertible preferred stock employed by venture capitalists in Silicon Valley in California.³⁵ The adaption of the *muḍāraba* from its classical structure, however, was precluded in the Muslim world due to constraints imposed by *fiqh*. The issue for the majority of jurists was that a thing established contrary to legal analogy (*qiyās*) cannot be used as an analogy for other things; since *muḍāraba* superseded basic rules of law and was in defiance of analogy, it could only be legalised on the grounds of social and economic necessity. It therefore had to suffer a legal limitation.³⁶ In keeping with other financial instruments, and other aspects of Islamic law, *muḍāraba* remained undeveloped. As Schacht says:

Islamic law, which until the early 'Abbāsīd period had been adaptable and growing, from then onwards became increasingly rigid and set in its final mold It was not all together immutable, but the changes which did take place were concerned more with legal theory and the systemic superstructure than with positive law.... Taken as a whole, however, Islamic law reflects and fits the social and economic conditions of the early 'Abbāsīd period, but has become more and more out of touch with later developments of state and society.³⁷

It is this rigidity in Islamic law that led in part to the deterioration of the early Islamic financial instruments, institutions and markets, leading to the eventual economic decline of the Muslim world.³⁸

It is therefore imperative to investigate the structure of Islamic financial intermediaries to realize what has gone awry with *muḍāraba* and how it can be revived. Dar and Presley state the following on the applicability of the *muḍāraba* in the real world.

“Almost all theoretical models of Islamic banking are either based on *muḍārabah* or *mushārahah* or both, but to-date actual practice of Islamic banking is far from these modes. Nearly all Islamic banks, investment companies, and investment funds offer trade and project finance on mark-

34 Murat Çizakça, *A Comparative Evolution of Business Partnerships: The Islamic World and Europe, with Specific References to the Ottoman Archive* (New York: Brill 1996).

35 *Ibid.*

36 See Hasanuz-Zaman, *supra* note 29 at 70; Udovitch, *supra* note 7.

37 *Supra* note 18 at 76–77.

38 See Timur Kuran, “Why the Middle East is Economically Underdeveloped: Historical Mechanisms of Institutional Stagnation”, *Journal of Economic Perspectives* 18 (2004): 71–90.

up, commissioned manufacturing, or on leasing bases. PLS (*i.e.*, Profit Loss Sharing based on *muḍārabah* or *mushārah*) features marginally in the practice of Islamic banking and finance.

Whatever is the degree of success of individual Islamic banks, they have so far failed in adopting PLS-based modes of financing in their business. Even specialised Islamic firms like *Mudārabah* Companies (MCos) in Pakistan, which are supposed to be functioning purely on a PLS basis, have negligible proportion of their funds invested on a *muḍārabah* or *mushārah* basis. According to the International Association of Islamic Banks, PLS covered less than 20 percent of investments made by Islamic banks world-wide (1996 figures). Likewise, the Islamic Development Bank (IDB) has so far not used PLS in its financial business except in a few small projects.”³⁹

In general, financial economists highlight the following advantages and disadvantages of the *muḍārabah* facility:

Advantages:

- It avoids fragility endowed in pure debt (or even traditional “Islamic” debt facilities of *murābaḥah* (cost plus mark-up), *tawarruq* (tripartite sale) and *qarḍ ḥasan* (benevolent loan).⁴⁰ This enhances the robustness of the financial system and is consistent with the Qur’ānic injunction of giving respite to borrowers in times of difficulty.⁴¹

Disadvantages:

- A restrictive requirement set by the dictates of the *fiqh* literature defines the sole responsibility of the *rabb al-māl* of providing 100% capital and solely being subject to losses. This constriction from creates an incentive (agency) issue, as the *muḍārib* has none of his/her capital at stake.⁴²
- Another form of inefficiency endowed by *fiqh* is in denying any form of control rights to the *rabb al-māl*.⁴³
- *Muḍārabah* suffers from the usual consequences of ex-ante and ex-post asymmetric information (*i.e.*, adverse selection and moral hazard, respectively).⁴⁴ It needs mechanisms to overcome these two problems.

It is sometimes suggested that *muḍārabah* is advantageous insofar as it adheres to the Qur’ānic injunction of avoiding expropriation of a counterparty’s assets.⁴⁵ The reality is that the *rabb al-māl* is not safeguarded in a classical *muḍārabah*

39 *Supra* note 28 at 3.

40 See M. Shahid Ebrahim and Mustapha Sheikh, “Debt Instruments in Islamic Finance”, Working Paper, Durham Business School (2014).

41 See Q2:280.

42 *Supra* note 28.

43 *Ibid.*

44 *Ibid.*

45 See Q2:275, Q2:278-279, Q2:281, Q3:130-132, Q4:161 and Q30:39.

arrangement to a requisite degree because he is made to bear all the risk, while the *muḍārib*, in contradistinction, bears no risk whatsoever.

5 Reviving the *Muḍāraba*

The disadvantages of the *muḍāraba* (as stated above) necessitate its revival in spirit in the form of a hybrid facility called participating preferred *ijāra* (PPI).⁴⁶ A PPI is structured by merging a special *ijāra* (leasing) facility with a *muḍāraba* one.⁴⁷ A preferred *ijāra* is akin to a preferred stock but backed by leases whose payoffs are capped and reduced. Through this special *ijāra* component, investors are bestowed with limited income in return for a share in the risk of the project. This feature of sharing in the risk cures the preferred *ijāra* of the fragility endowed in its regular counterpart, making it compliant with the Qur'ānic injunction of giving respite to borrowers in times of difficulty.⁴⁸ In contrast, the *muḍāraba* component bestows a share in operating income along with any appreciation at the terminal stage and mitigates fragility of the venture.

The resulting hybrid facility (*i.e.*, PPI) is basically a true Profit and Loss sharing one without the major disadvantages of the *muḍāraba*, as elaborated below. It confers the following benefits:

- It is extremely malleable into family of financial instruments catering to the needs of a diverse clientele. That is, it ranges from a pure income bond (*i.e.*, *muqāraḍa* bond) to a pure growth facility (like the classic *muḍāraba*).⁴⁹
- The financier: (i) is ranked ahead of the owner of the firm (or project); and (ii) subsidises a 'capped' fixed portion (from the *ijāra* component of the facility) in return for a 'proportion' (or a fraction) of payoffs in the operating or terminal states of the economy (or both).
- It resolves adverse selection, as it is asset-backed.
- It alleviates the fragility of the financial system. This enhances the robustness of the financial system.
- It allows an investor to retain control of the firm even in the good state of the economy, unlike convertible debt, where the conversion to equity dilutes these control rights.

A PPI, however, needs to be priced to avoid expropriation of the assets of a counterparty. It also needs a mechanism to overcome moral hazard.⁵⁰

46 See M. Shahid Ebrahim, Murizah O. Salleh and Mustapha Sheikh, "Rationalising Hybrid Financial Instruments from an *Uṣūlī* Perspective", *Arab Law Quarterly* 28 (2014).

47 *Ibid.*

48 See Q2:280

49 See M. Shahid Ebrahim, "Integrating Islamic and Conventional Project Finance", *Thunderbird International Business Review* 41 (1999): 583–609.

50 *Supra* note 46.

6. Conclusion

Hasanuz-Zaman has argued that the importance of the *muḍāraba* facility in Islam has been overstated: “*Shirkah* and *Muḍārabah* are not sacrosanct nor are they end-all of financial or business relationship”.⁵¹ While the authors are minded to agree with this assessment, the reality on the ground runs counter to this; in fact, recent history demonstrates the widespread call from various Muslim quarters for a renewed implementation of these facilities, particularly the *muḍāraba*, in their classical form. Yet the failure to adapt facilities such as the *muḍāraba* has highlighted the uneasy relationship between intellectual rigidity and economic malaise, with consequences which have for centuries had a crippling effect on Muslim economies. This article has highlighted that static and flawed *ijtihād* (interpretation or deduction of the divine sources of law) stemming from the rigid rules of *taqlīd* (blindly imitating religious authority) has played a significant role in the perennial underdevelopment of the Muslim world. Muslim jurists failed to undertake a dynamic *ijtihād*⁵² by adapting organisational forms which would have allowed businesses to competitively deliver the products demanded by their customers at the lowest cost by mitigating transaction costs.⁵³ Thus there is therefore a need to develop these organizational forms in conjunction with optimal financial instruments,⁵⁴ a technical design based on the seminal study of Miller,⁵⁵ which would link organizational forms with their underlying capital structure.

In summary, there is an exigency to overhaul the *fiqh* literature developed in the classical period through the employment of a joint *ijtihād* (juristic interpretation), that galvanises the efforts of various experts, as encouraged by al-Alwānī.⁵⁶ It is hoped that this paper demonstrates how this might be achieved vis-à-vis the classical *muḍāraba* facility, and its restructuring along the lines of a participating preferred *ijāra*.⁵⁷

51 *Supra* note 29 at 85.

52 See Abdulmajeed H. Bello, “Dynamic Approach to the Shari’ah: A Case Study of *Ijtihād* and its Application in Contemporary Society”, *Arab Law Quarterly* 27 (2013): 259–270.

53 See Ronald H. Coase, “The Nature of the Firm”, *Economica* (4) *New Series* (16) (1937): 386–405; and Armen A. Alchian, “Uncertainty, Evolution and Economic Theory”, *Journal of Political Economy* 58 (1950): 211–221.

54 This is elaborated in M. Shahid Ebrahim and Ike Mathur, “On the Efficiency of the UPREIT Organizational Form: Implications for the Subprime Crisis and CDO’S”, *Journal of Economic Behavior and Organization* 85 (2013): 286–305.

55 Merton H. Miller, “Debt and Taxes”, *Journal of Finance* 32 (1977): 261–275.

56 Tāha Jābir al-Alwānī, “The Role of Islamic *Ijtihād* in the Regulation and Correction of Capital Markets”, *American Journal of Islamic Social Sciences* 14(3) (1997): 39–66.

57 *Supra* note 46.