

THE CONCEPT OF 'MUDARABAH' AND ITS PRACTICE IN ISLAMIC FINANCIAL INSTITUTIONS IN SRI LANKA: AN EMPIRICAL STUDY

Mr.MCA. Nazar¹ and Mr. TM.Rimsan²

¹ Senior Lecturer in Accounting, FMC – SEUSL, mcanazar@seu.ac.lk

² Teacher, rimsantm@gmail.com

Literature review

The Islamic banking system at a momentous pace since its inception three decades ago, the number of Islamic Financial Institution worldwide has risen to over 500 institutions in more than 75 countries. In Sri Lanka, could be traced back in 1997 with the establishment of Amana investment limited to operate interest free bank. As well as conventional bank also allowed after revising Act No 30 of 1988, as amended in 2005, allows both commercial banks and specialized banks to operate on a Shari'ah compliant basis. Presently MCB Bank, People's Leasing, LOLC, Bank of Ceylon and the new entrants, NDB bank, HNB Samurdi Bank are the Central Bank of Sri Lanka regulated institutions offering Islamic financial services.

Generally, Banks have performed an important role and have very successfully served the needs of people by channelizing the savings of the

people where they needs. They have been in a position to offer the needed funds through banks credit to businessmen for investment purpose on the payment of interest but most important matter in Islamic economics is prohibition of usury (interest) which is the main source of income in conventional banking system.

Islamic finance is fundamentally different from the conventional finance model as it is based on a Profit and Loss Sharing (PLS) structure; People are becoming attentive of the Islamic finance in its products. The main

mission of these institutions has been an achievement of social and economic development through the delivery of financial services in line with principles and teaching of Islam. Therefore, Islamic finance derived its principles from the Shari'ah, which in turns based on Quran and Sunnah. So Islamic financial institution avoid any investment or financing seen as contrary to the Shari'ah, such as interest based deposits and loans or investment in alcohol, gambling, pork and the sensual entertainment which are harm to social and economic development

So the first Islamic bank established in 1963 Mit Ghamr, Egypt was made by Ahmad El Najjar. The bank was socially oriented and lasted until 1967(Ahmad). It predominantly entered into *Mudarabah* contracts with the savings it received. Other banks began to copy this model.

In general, we have known that the entire conventional banking system depends on modest interest. They paid and charged interest for the every deposits and loan advanced to the customers. However, with the prohibition of interest by Shari'ah how Islamic financial institutions have to do finance with their customers? They cannot accept interest based deposits or advance loan. Therefore, they use Shari'ah compliant products such as *Mudarabah*, *Musharaka*, *Ijara*, and *Salam* etc. as an alternative form for interest based financing. There is a lack of knowledge about the various Islamic-banking practices among the banking community as well as the banks' customers, especially on *Mudarabah* which basic tool of Islamic financial institutions. They

have misconception on *Mudarabah* that it is similar to interest based investment and saving scheme like conventional banks do. They expect guaranteed return of capital, and fixed amount of profit, etc.

Purpose of the study

The study has been carried out with practice of *Mudarabah*. To clarify the practice and the concept of *Mudarabah* and its application in approved manner of Shari'ah in Islamic finance as a mode of finance. In addition, to examine method of using *Mudarabah* as mode of finance to identify any element that contravene to Shari'ah. And also examine its implementation in Sri Lanka. Some questions arise while doing study.

Do Islamic financial institutions in Sri Lanka use *Mudarabah* in an approved manner of Shari'ah? It is the main research problem. It is analyzed that the following research questions.

Methodology

This kind of study mostly covers the qualitative data therefore this study will be adopted qualitative research method to get the justifications and explanations behind the practice of *Mudarabah* for unrestricted investment deposits. The strengths and its attributes in qualitative method seen to be more appropriate in deciding the method to be applied in this study.

The sample consists of three major players in Islamic finance in Sri Lanka, which is ABL, Al-Safa PLC and LOLC – Al-Falah Islamic Unit. Random selection of customers of each institution and the professionals were interviewed to record their opinion about *Mudarabah* transaction. Findings of the study were consulted with the available literature and executives of the banks to confirm their reliability and acceptability.

Table 1 Populations and Sample of Bankers

banks	o.	N	of ample	Percentage	Pe
	population		selected	(%)	
BL	0	35	3	57%	6.
Al-Falah LOLC	5	12		40%	6.
Al-Safa PLC	8	10		70%	3.
total	3	58	5	00%	6.

Table 1 Populations and Sample of customers

banks	o.	N	of ample	Percentage	Pe
	population		selected	(%)	
BL	,200	60	4	04%	0.
Al-Falah LOLC	700	25	0	04%	0.
Al-Safa PLC	900	18	0	05%	0.
total	4,800	10	4	04%	0.

The primary data collection was carried out using a self-designed questionnaire, this adopted instrument comprises three sections, and the first section covers the personal information (position, Name of the Bank attached, Experience, and educational qualification). The second section contains (05) some information about practice of *Mudarabah*, The third section contains (15) Shari'ah Related Inspection Issues on *Mudarabah*, Five Likert-type scales were used to score the responses. In addition, the Primary data was collected through interview methods, and observation. The sets of standard questionnaire were used in the survey, among the professionals, employees, as well as customers of selected Islamic financial institutions in Sri Lanka who were interviewed to record their opinions. The questionnaires were distributed to these three Islamic financial institutions representing various types of Islamic finance in Sri Lanka. The questionnaire asked

various pertinent questions, which intended to elicit the bankers' and depositors' opinions, perceptions, and attitudes towards the unique characteristics of Mudarabah contract as specified in *Shari'ah Muamalah* principles. The characteristics among others are: (i) profit and loss sharing; (ii) management of Mudarabah pool; (iii) concept of Capital Contribution. A total 79 of the returned questionnaires were complete and fit for analysis purpose.

The secondary data was collected in the following way

- Financial reports of selected financial institutions, market reports, annual reports.
- Private research publishers and *Shari'ah* standards
- Independent variable – Profit and Loss Sharing, Capital contribution and Management of Mudarabah pool
- Dependent variable – Practice of Mudarabah

Descriptive techniques such as; frequencies, percentages, means, standard deviation (Std.) and charts, graphical illustrations etc. also are used. Spearman correlation, multiple regression analysis, and Chi-Squared Test are used to test hypothesis of the study.

Regression analysis is used to predict the nature and closeness of relationship between two or more variables. It evaluates the casual effect of one variable on another variable. In addition to that, it used to predict the variability in the dependant variable based on the information about one or more independent variables. In this study, multiple regression models have been used. It drives following equations:

$$\hat{Y} = \beta_0 + \beta_1x_1 + \beta_2x_2 + \beta_3x_3$$

Where,

Y = dependant variable - "practice of Mudarabah"

x_1, x_2, x_3 = independent variables - "some principles of Mudarabah"

x_1 = Profit sharing, x_2 = Management of Mudarabah pool, x_3 = Capital contribution

- Islamic banking publications such as, books, journals, periodicals, abstracts, indexes, directories, research reports, conference papers, internal records of organizations, newspapers and magazines
- On-line databases, Internet, videos and broadcasts

The conceptual framework describes the factorial outlines to be analyses through the study. It is important to form a framework when undertaking any analysis. It is better to obtain the results through this framework. Thin it is easy to find out the relationship among them. The conceptual model dearly depicts the pattern of relationship among key variables.

β_0 = Y - intercept when x is zero - regression constant

$\beta_1, \beta_2, \beta_3$ = slope of the line - regression coefficient

Discussion & Findings

This study was undertaken with the objective of evaluating the acceptance of the fundamental Shari'ah principles of Mudarabah contract characteristics in deposits account product by Sri Lankan Islamic financial institution. In meeting this broad objective, the views and opinions from the sampled Islamic banks' depositors were obtained by distributing the survey questionnaires; the results of the survey were analyzed and compared with the fundamental theories and related literature

The purpose of this study is to describe the concept of *Mudarabah* and its application in approved manner of shariah in Islamic finance as a mode of finance. Thus in this study some importance principles of Shari'ah was inspected. Especially, for this study some principles analyzed under major three themes: Profit loss sharing in practice of Mudarabah, Management of Mudarabah pool and Capital Contribution to the Mudarabah pool by Depositor. Secondary objectives of this study is to

examine method of using *Mudarabah* as mode of finance, to identify the any elements contravene to Shariah and to examine its implementation in Sri Lanka.

The answers to the study questions are find out end of the study. Islamic financial institution when practicing *Mudarabah* there was some criticism about their practices. However after this survey understood there is no any elements that be in breach of to Shari'ah. Nevertheless, customer may expect the something while practicing of *Mudarabah* as well as conventional deposit system because of their intention to serve their money without any risk. They are expecting fixed return of profit, guaranteed return of initial capital etc.

According to the study, it is concluded that the profit sharing is very important element in practicing *Mudarabah* on approved manner of Shari'ah. In the study, most of the bankers and customer granted that

Model Summary^b

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.881 ^a	0.664	0.642	0.22065

a. Predictors: (Constant), X3, X1, X2

b. Dependent Variable: Y1

Table 3 Model Summery

In the Table above, r square is called the coefficient of determination and referred to as r². In this study, 66.4% of the variability in performance can be explained by principles the remaining 33.6% of variability is due to other unexpected factors. Thus, this further supported the rejection of the H0 hypothesis and acceptance of alternative hypothesis.

The R- squared (R²) for the regression is 0.664 and the R-square adjusted for degrees of freedom for the regression is 0.642. The root mean square error, labeled 'Root MSE' is .22065. It should be noted that the root mean square error is the square root of the mean square error reported for the residual in the ANOVA Table

profit and loss sharing principle is significant element in practice of *Mudarabah*. In addition, it is concluded that the Management of *Mudarabah* pool is also very important element in practicing *Mudarabah* on approved manner of Shari'ah. In the study, most of the bankers and customer granted that Management of *Mudarabah* pool is significant element in practice of *Mudarabah*. and it is concluded that the Capital Contribution is also very important element in practicing *Mudarabah* on approved manner of Shari'ah. In the study, most of the bankers and customer granted that Capital Contribution is significant element in practice of *Mudarabah*

Multiple regression analysis expose of the fitted line of the variables. The results of regression analysis are as follows:

ANOVA^b

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	7.093	3	2.364	21.626	0.000 ^a
	Residual	8.200	75	0.109		
	Total	15.293	78			

a. Predictors: (Constant), X3, X1, X2

b. Dependent Variable: Y1

According to the ANOVA table, Since P- Value = 0.000^a < 0.05, then reject H₀. Therefore at 5% significance level, statistically conclude that, there is

significant between Practice of Mudarabah and Selected Principles of Mudarabah

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-3.213E-17	0.037		0.000	1.000
	X1	0.479	0.091	0.502	5.236	0.000
	X2	0.181	0.089	0.196	2.040	0.045
	X3	0.180	0.084	0.185	2.137	0.036

a. Dependent Variable: Y1

Table 4 Coefficient Table

Fitted multi linear regression line is:

$$\hat{Y} = \beta_0 + \beta_1x_1 + \beta_2x_2 +$$

$$\beta_3x_3$$

According to the coefficient table:

$$\beta_0 = -3.213E-17 \text{ (Constant)}$$

$$\beta_1 = 0.479 \text{ (Profit and Loss Sharing)}$$

$$\beta_2 = 0.181 \text{ (Management of Mudarabah Pool)}$$

$$\beta_3 = 0.180 \text{ (Capital Contribution)}$$

$$\hat{Y} = (-3.213E-17) + 0.479 x_1 + 0.181 x_2 + 0.180 x_3$$

If lack of Profit and Loss Sharing is increased by one, practice of Mudarabah will be increased by 0.479. If Management of Mudarabah Pool is increased by one, practice of Mudarabah will be increased by 0.181. If Capital Contribution is increased by one, practice of Mudarabah will be increased by 0.180. In this multiple linear regression model, the constant value is 1.000 indicates, model is constant.

Conclusion

End of the study Find out that the Islamic financial institution faces some criticism while practicing *Mudarabah*. However after this survey understood there is no any elements that be in breach of to *Shari'ah*. Nevertheless, some customer may expect fixed return of profit, guaranteed return of initial capital etc without bearing any risk as conventional system. This is because of lack of awareness of practice of *Mudarabah*.

Only three major principles are taken for this study. There are numerous Features, which compliant with *Shari'ah*. All the principles can identify and study broadly. According to interviews of Islamic banking scholars for this study, today 'competition with other conventional banks and Islamic banking window' is major problem to IFIs. Therefore, it can study broadly

Key words: Islamic banking, Islamic finance, Mudarabah, profit, and loss sharing

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