

The Principles and Practices of Shariah in Islamic Finance

Shariah Standard on
MUDARABAH



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

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PART A OVERVIEW

1. Objective

1.1 The purpose of Shariah Standards is to provide standard on features of Shariah contracts applicable in Islamic financial transactions. The document facilitates the understanding of a particular Shariah contract requirement. The required and optional features specified in the Standards shall serve as standards for the Islamic financial institution to apply a particular Shariah contract in developing Islamic financial products and services. The Standards is expandable to address the dynamism of Islamic finance activities.

1.2 The provisions in the Shariah Standards is divided into:

- (a) **“Standards”** are labelled as (S). Standards are essential features of a particular Shariah contract as provided under Shariah and shall be adhered to. Standards are issued pursuant to substantive provisions in the relevant laws administered by the Bank and are binding. In the event of non-compliance, the Bank may take enforcement actions.
- (b) **“Practice Guides”** are labelled as (PG). Practice Guides are optional features of a particular Shariah contract as provided under Shariah and may be implemented.

2. Legal provisions

2.1 The Shariah Standards is issued pursuant to section 59 of the Central Bank of Malaysia Act 2009.

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3. Applicability

- 3.1 The Shariah Standards is applicable to any Islamic financial institution carrying Islamic financial business and shall include:
- (a) Islamic banks licensed under the Islamic Banking Act 1983 (IBA);
 - (b) Banks licensed under the Banking and Financial Institutions Act 1989 (BAFIA) and approved to carry on Islamic banking business under section 124 of BAFIA;
 - (c) Development financial institutions prescribed under the Development Financial Institutions Act 2002 (DFIA) and approved to carry on Islamic banking business under section 129 of DFIA; and
 - (d) All takaful operators registered under the Takaful Act 1984.

[All the above institutions are hereafter referred to as Islamic Finance Institutions (IFIs)].

4. Issuance date

- 4.1 The Shariah Standard on *Mudarabah* is issued on 22 October 2012.

5. Effective date

- 5.1 The effective implementation date is 1 January 2014.

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6. Relationship with existing policies

- 6.1 The Shariah Standards is issued in accordance to rulings of the Shariah Advisory Council (SAC) of Bank Negara Malaysia.¹
- 6.2 Shariah Standards is a published ruling of the SAC.
- 6.3 IFIs shall refer to Shariah Standards document in applying a particular Shariah contract as part of its implementation of Shariah compliance function outlined in the “Shariah Governance Framework for Islamic Financial Institutions.”

¹ The Shariah Standard on *Mudarabah* was finalized and endorsed in the 127th SAC meeting.

PART B DEFINITION AND NATURE

7. Definition

- S** 7.1 *Mudarabah*² is a contract between a capital provider (*rabbul mal*) and an entrepreneur (*mudarib*) under which the *rabbul mal* provides capital to be managed by the *mudarib* and any profit generated from the capital is shared between the *rabbul mal* and *mudarib* according to mutually agreed profit sharing ratio (PSR) whilst financial losses are borne by the *rabbul mal* provided that such losses are not due to the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).

8. Nature of *mudarabah*

- S** 8.1 *Mudarabah* is a contract based on fiduciary relationship (*aqd al-amanah*). Under this principle, *mudarib* manages the *mudarabah* asset in trust and is not liable for the impairment of the asset except for impairment which is a result of the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- S** 8.2 Any of the contracting parties has the right to terminate the contract unilaterally except in the following conditions:
- (a) The *mudarib* has commenced the work relating to the management of the capital of the *rabbul mal*; or
 - (b) Contracting parties have agreed to enter into a *mudarabah* for a specified time or have agreed not to terminate the contract within a specified time.

² The terms *muqaradah* and *qirad* are synonymous to *mudarabah*.

8.3 *Mudarabah* is categorized into two types:

- S** (a) Unrestricted *Mudarabah* (*Mudarabah Mutlaqah*) is a contract in which the *rabbul mal* permits the *mudarib* to manage the *mudarabah* capital without any specific restriction.
- (b) Restricted *Mudarabah* (*Mudarabah Muqayyadah*)
- S** (i) A restricted *mudarabah* is a contract in which the *rabbul mal* imposes specific restriction on the *mudarabah* terms.
- PG** (ii) The *rabbul mal* may specify conditions restricting *the mudarib* such as the determination of location, period for investment, type of project and commingling of funds.
- PG** 8.4 The contracting parties may mutually agree to change the type of *mudarabah* they have entered into to another type of *mudarabah* at any point of time.

PART C COMPONENTS OF *MUDARABAH*

9. Contracting parties

- S** 9.1 The contracting parties in *mudarabah* consist of *rabbul mal* and *mudarib*.
- S** 9.2 *Rabbul mal* and *mudarib* shall have legal capacity³ to execute contract including the capacity to perform agency (*wakalah*) contract either as a principal or as an agent.
- PG** 9.3 The contracting parties in *mudarabah* may be a natural person or a legal person.
- PG** 9.4 The contracting parties in a *mudarabah* contract may involve more than one *mudarib* or *rabbul mal*.
- PG** 9.5 In the case of *mudarabah* involving more than one *rabbul mal*, an agreement among the *rabbul mal* may be established whereby:
- (a) An existing *rabbul mal* agrees to relinquish his right over certain portion of profit if he withdraws from the *mudarabah* prior to its maturity date; and
 - (b) A new *rabbul mal* agrees to assume liability in respect of the *mudarabah* which is already in operation prior to his participation.

³ The legal capacity of a person is defined as capacity to have rights and responsibilities; and capacity to have legal effect to his action. Among the important conditions are that the person must possess sound mind and the capacity to distinguish between what is harmful or beneficial to one's interests.
Legal capacity of a legal entity is defined as eligibility of an entity to acquire rights and assume responsibilities.

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10. Management of *mudarabah*

- S** 10.1 *Mudarib* shall have the right to manage *mudarabah* venture.
- S** 10.2 *Mudarib* is responsible to ensure proper management of the *mudarabah* venture and acts in the interest of the *rabbul mal*.
- S** 10.3 Mandate of the *mudarib* shall be provided under the terms and conditions of the contract.
- PG** 10.4 *Mudarib* may assign *mudarabah* capital under his management to another *mudarib* in another *mudarabah* (*mudarib yudarib*) or to another manager (*wakil*) subject to the condition that the consent of *rabbul mal* is obtained.
- S** 10.5 *Rabbul mal* shall not involve in managing *mudarabah* venture but shall have a right of access to reasonable information regarding the *mudarabah* venture.

11. Capital

- S** 11.1 Capital is an asset provided by *rabbul mal* to the *mudarib* for the purpose of *mudarabah*.
- S** 11.2 *Mudarabah* capital shall be provided by *rabbul mal* and managed by the *mudarib*.
- S** 11.3 *Mudarabah* capital shall be identifiable, readily available and accessible for *mudarib* to commence business activities.
- PG** 11.4 *Mudarabah* capital may be in the form of cash or in-kind which may include intangible assets.
- S** 11.5 Capital in-kind shall be valued based on the valuation determined by a

third party which may include experts, valuers or as agreed upon by the contracting parties at the inception of the contract.

- S** 11.6 *Mudarabah* capital denominated in different currencies shall be valued based on a specific currency agreed by the contracting parties at the inception of the contract.
- S** 11.7 *Mudarabah* capital shall not be in the form of a debt due to *rabbul mal* either from *mudarib* or a third party.
- S** 11.8 All remaining capital shall be returned to the *rabbul mal*, if any, upon dissolution or termination of the *mudarabah* contract.
- S** 11.9 Any amount of capital due to *rabbul mal* under paragraph 11.8 and profit, if any, shall be deemed as liability due to the *rabbul mal*.
- S** 11.10 The *mudarib* shall not guarantee the *mudarabah* capital except in the case of his misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*).
- PG** 11.11 *Rabbul mal* and *mudarib* may agree for a gradual withdrawal of *mudarabah* capital by the *rabbul mal*.
- PG** 11.12 *Mudarib* may with the consent of *rabbul mal* commingle the *mudarabah* capital with other investment fund.
- S** 11.13 Pursuant to paragraph 11.12, *mudarib* shall observe the agreed terms and conditions of the respective contract.
- PG** 11.14 *Mudarib* may inject his own fund into the *mudarabah* capital subject to the consent of *rabbul mal* and hence a *musharakah* contract is formed between the *mudarib* (as partner under *musharakah*) and the *mudarabah* venture.
- PG** 11.15 *Mudarabah* expenditure may be charged to *mudarabah* capital.

- S** 11.16 The *mudarabah* expenditure shall be direct expenses that are identifiable and measurable with regard to a specific investment activity⁴.
- PG** 11.17 The capital may be fully or partially disbursed as per the terms of the contract.
- 11.18 The effect of a failure of *rabbul mal* to provide capital under a *mudarabah* contract (defaulting *rabbul mal*) in the following situations shall be as follows:
- PG** (a) **No capital has been paid.**
In this situation, the contracting parties may unilaterally terminate the contract. If the *mudharib* has commenced work, the *rabbul mal* has to reimburse the *mudharib* for any *mudarabah* expenditure incurred and pay the *mudharib* fair and reasonable wages or fees.
- PG** (b) ***Mudarabah* contract involving one *mudharib* and one *rabbul mal* with staggered capital payment.**
In this situation the contracting parties may, subject to the terms and conditions of the contract:
- (i) revise the *mudarabah* contract based on the actual capital provided;
or ,
 - (ii) terminate the contract and consequently:
 - a) *Mudharib* shall return the capital contributed to the *rabbul mal* if any and share the profits with the *rabbul mal*, if any;
and
 - b) *Rabbul mal* shall bear the *mudarabah* expenditure incurred by *mudharib*. If the justified *mudarabah* expenditure⁵ incurred exceeds the actual capital contribution, such

⁴ Investment activity in the context of this paragraph refers to Shariah compliant profit generating activities which may include Shariah compliant provision of finance provided by *mudharib* using *mudarabah* fund.

⁵ Explanation on *mudarabah* expenditure is provided under paragraph 11.16

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liability shall be borne by the *rabbul mal* up to the limit of the total capital amount committed under the contract.

- PG** (c) ***Mudarabah* contract involving one *mudarib* and multiple *rabbul mal* with single capital payment by each *rabbul mal* where one or more *rabbul mal* failed to pay.**

In this situation, the *mudarib* may agree to terminate the *mudarabah* contract with *rabbul mal* who failed to pay and may based on agreed terms impose on him to indemnify the *mudarabah* venture for any expenses incurred due to his default.

- PG** (d) ***Mudarabah* contract involving one *mudarib* and multiple *rabbul mal* with staggered capital payment by each or some of the *rabbul mal* where one or more *rabbul mal* failed to pay the subsequent capital.**

In this situation, the non-defaulting contracting parties shall have the following remedies including:

- (i) requiring the defaulting *rabbul mal* to sell his interest to the other *rabbul mal* or a third party;
- (ii) the non-defaulting contracting parties may agree to revise *the mudarabah* contract based on actual capital paid; or
- (iii) the non-defaulting contracting parties may agree to terminate the *mudarabah* contract with the defaulting *rabbul mal* and may, based on agreed terms, require him to indemnify the *mudarabah* venture for any expenses incurred due to his default.

12. Profit

- S** 12.1 Profit sharing is the primary motive of the *mudarabah* contract and therefore it is a fundamental component of the contract.
- S** 12.2 Profit is the value created over and above the *mudarabah* capital which

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is determined based on profit determination method acceptable by market standard or practices.

- S** 12.3 The *mudarib* shall not guarantee any profit.
- S** 12.4 *Rabbul mal* and *mudarib* shall share profit based on a ratio mutually agreed between them.
- S** 12.5 PSR shall be determined at the inception of the contract. Nonetheless, PSR may be revised during the tenure of the *mudarabah* subject to mutual agreement.
- S** 12.6 *Mudarabah* contract shall not stipulate a pre-determined fixed amount of profit to one contracting party which deprives the profit share of the other contracting party.
- S** 12.7 The profit in the form of certain percentage shall not be linked to the *mudarabah* capital amount.
- PG** 12.8 Notwithstanding paragraph 12.7, the ex-post performance profit amount (based on the PSR which had been mutually agreed upon between the *rabbul mal* and the *mudarib*) may be translated into a fixed percentage yield of the *mudarabah* capital amount.
- PG** 12.9 In a multi-tiered *mudarabah*, two or more profit sharing arrangements may be agreed upon. In the first tier, *rabbul mal* and *mudarib* may agree on a certain PSR. Whilst in the second tier the *rabbul mal* (*mudarib* in the first tier *mudarabah*) and the other *mudarib* may agree for another PSR. Such arrangement may apply to the following tier respectively. The profit generated in each tier shall be shared according to the respective PSR.
- S** 12.10 In the case where *mudarib* commingled or injected his own fund to the *mudarabah*, the *mudarib* is entitled to the profit based on his capital contribution in the commingled fund and the remaining profit shall then

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be distributed based on PSR in the *mudarabah*.

- PG** 12.11 *Rabbul mal* and *mudarib* may agree on a PSR for a certain threshold of profit. If the actual profit exceeds the threshold, the excess amount may be distributed based on a different PSR agreed by the parties or be paid to any of the contracting parties as per agreement.
- PG** 12.12 *Rabbul mal* and *mudarib* may agree on a threshold of profit whereby in the case of profit generated exceeds the threshold, an amount of profit equivalent to threshold is paid to one of the contracting parties and the remaining is shared according to PSR. In the case of profit generated is below the threshold, the profit is shared based on PSR.
- PG** 12.13 The agreed PSR may vary to correspond with different periods of investment, different amount of capital or due to pre-mature withdrawal of capital provided that such conditions are agreed upon at the inception of the *mudarabah* contract.
- S** 12.14 In a single *mudarabah* contract involving more than one *mudarib*, a common profit sharing ratio is agreed between *rabbul mal* and all the *mudarib*. All *mudarib* shall share the *mudarib*'s profit portion as per agreed terms.
- S** 12.15 Profit shall be recognized based on the following methodology:
- (a) Realized basis by actual liquidation of assets of *mudarabah* partnership (*al-tandid al-haqiqi*); or
 - (b) Constructive basis according to acceptable profit recognition method which may include valuation according to acceptable market methodology, independent valuation or valuation based on estimated figures (*al-tandid al-hukmi*).

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- 12.16 In the case of profit recognised based on constructive basis:
- PG S** (a) a profit reserve may be created; and
- S** (b) a final consolidation and adjustment shall be undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual amount of profit.
- S** 12.17 Profit shall be distributed upon the maturity of the *mudarabah* or at an agreed period.
- S** 12.18 Unrealized gains recognized during the *mudarabah* tenure shall be recognized as profit and be included in the profit and loss calculation for the *mudarabah*.
- S** 12.19 A *mudarib* is only entitled to profit for works which are integral to the *mudarabah* venture and shall not earn any additional fee for such works.
- PG** 12.20 *Rabbul mal* may commission *mudarib* for a fee to perform works apart from the works integral to *mudarabah* venture.
- PG** 12.21 A party may waive his right to the profits, if any, to the other contracting party on the basis of waiver (*tanazul*) on the date of distribution of the profit.
- PG** 12.22 The parties to the contract may agree to set aside the profit as a reserve (e.g. profit equalization reserve) or for any other purpose.
- S** 12.23 In relation to paragraph 12.22, the reserve shall only be created from the profit of the *mudarabah*.
- S** 12.24 In case where profit reserved is utilised to cover depletion of *mudarabah* capital, only the profit portion of the *rabbul mal* in the reserve shall be utilised⁶.

⁶ This requirement is specified to prevent implication of capital guarantee by *mudarib*.

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- PG** 12.25 Contracting parties may agree to a condition whereby *rabbul mal* may be subject to lower or no profit payment if capital is withdrawn before the maturity of the investment period.

13. Loss

- S** 13.1 A loss is depletion from the value of capital.
- S** 13.2 Loss shall be borne by the *rabbul mal* up to the capital value.
- S** 13.3 The *mudarib* shall not be liable for any impairment of asset unless such loss is due to the *mudarib*'s misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) of the contract.
- S** 13.4 Notwithstanding paragraph 13.3, in the case of loss the *mudarib* shall furnish the reason for the occurrence of loss.
- S** 13.5 In the case of multiple *rabbul mal* in a single *mudarabah*, the loss shall be borne by each *rabbul mal* proportionate to his capital contribution.
- S** 13.6 In the case where *mudarib* commingled or injected his own fund to the *mudarabah*, the loss shall be borne based on the proportion of the *mudarib*'s capital contribution in the commingled fund.
- PG** 13.7 The *mudarib* may voluntarily absorb the loss upon the maturity or dissolution of *mudarabah*.

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PART D ARRANGEMENT OF *MUDARABAH* WITH OTHER CONTRACT

14. Arrangement for guarantee in *mudarabah*

- S** 14.1 *Mudarib* shall not guarantee the capital and/or profit.
- 14.2 Notwithstanding paragraph 14.1, the following measures may be exercised:
- PG** (a) The *rabbul mal* may take collateral from the *mudarib*, provided that the collateral could only be liquidated in the event of misconduct (*ta`addi*) or negligence (*taqsir*) or breach of terms (*mukhalafah al-shurut*) of contract by the *mudarib*; or
- PG** (b) The *rabbul mal* may require the *mudarib* to arrange for an independent third party guarantee by observing the following requirements:
- S** (a) The guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital.
- S** (b) The third party guarantor shall be independent from the *mudarib* such that it shall not be a related party where the *mudarib* has majority ownership and/or having control in the entity nor shall it be an entity that owns or having controls over the *mudarib*.
- PG** (c) The third party guarantee may be in the form of performance guarantee of the *mudarabah* transactions or guarantee on *mudarabah* capital.

15. Arrangement of *mudarabah* with *wadiah*, *wakalah* or *musharakah*

- PG** 15.1 Contracting parties may agree to an arrangement whereby a certain amount of fund is assigned as *mudarabah* capital and another portion of the fund is assigned under *wadiah*, *wakalah* or *musharakah* contracts.

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- S** 15.2 Pursuant to paragraph 15.1, the contracting parties shall observe requirement of *mudarabah* on the part of fund assigned under *mudarabah* and shall observe requirement of *wadiah*, *wakalah* or *musharakah* on the part of fund assigned under the respective contract.

16. Arrangement of *mudarabah* with *hibah* or *hadiyyah*

- PG** 16.1 *Mudarib* may provide *hibah* or *hadiyyah* to *rabbul mal* subject to the following conditions:
- S** (a) *Hibah* or *hadiyyah* shall not be sourced from *mudarabah* capital or *rabbul mal's* portion of profit.
- S** (b) Provision of *hibah* or *hadiyyah* shall not amount to a guarantee of capital and/or profit by *mudarib*.

PART E DISSOLUTION

17. Dissolution of *mudarabah*

17.1 The *mudarabah* contract may be dissolved under the following circumstances:

- S** (a) Unilateral termination by any of the parties in the absence of any prohibitive circumstances as per paragraph 8.2;
- S** (b) Unilateral termination by any of the parties due to misconduct (*ta`addi*), negligence (*taqsir*) or breach of specified terms (*mukhalafah al-shurut*) of contract by the other;
- S** (c) Mutual agreement to terminate between the parties;
- S** (d) Contract expires upon the maturity date agreed by the parties;
- S** (e) Demise or dissolution of either *mudarib* or *rabbul mal* or loss of legal capacity;
- S** (f) Invalidity of *mudarabah*.

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APPENDICES

18. Appendix 1 Legitimacy of *mudarabah*

18.1 The legitimacy of the *mudarabah* contract is derived from the *Quran*, and founded on the *Sunnah* of the Prophet Muhammad (peace be upon him), and the consensus of Muslim jurists (*Ijma*⁷).

The *Quran*

18.2 The following verse of the *Quran* implies the general permissibility of commercial ventures including *mudarabah*.

(a) وَأَخْرُونَ يَضْرِبُونَ فِي الْأَرْضِ يَبْتَغُونَ مِنْ فَضْلِ اللَّهِ

“...and others travelling in the earth in quest of Allah’s bounty...”⁷

The word (يَضْرِبُونَ) in the verse implies permissibility to travel in managing wealth to seek the bounty of Allah SWT which may take the form of *mudarabah*.

The *Sunnah* of The Prophet Muhammad (peace be upon him)

18.3 عن ابن عباس قال: كان العباس بن عبد المطلب إذا دفع مالا مضاربة اشترط على صاحبه أن لا يسلك به بحرا، ولا يتزل به واديا، ولا يشتري به ذات كبد رطبة، فإن فعل فهو ضامن، فرفع شرطه إلى رسول الله صلى الله عليه وسلم فأجازه.

“Ibnu Abbas (may Allah be pleased with him) reported that: “When Abbas Ibn Abd al-Muttalib gave his property to someone for *mudarabah*, he stipulated conditions for his partner not to bring the capital onto the sea; and not to bring with him the capital crossing a valley; and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These

⁷ Surah *al-Muzzammil*, verse 20.

conditions have been brought to the attention of Prophet Muhammad (peace be upon him) and he approved them.”⁸

18.4 عن صالح بن صهيب عن أبيه قال: قال رسول الله صلى الله عليه وسلم: (ثلاث فيهن البركة: البيع إلى أجل والمقارضة وأخلط البر بالشعير للبيت لا للبيع)

“Suhayb (may Allah be pleased with him) reported that the Prophet Muhammad (peace be upon him) said: Three matters that have the blessing (of Allah): A deferred sale, *muqaradah* (*mudarabah*), mixing wheat with barley for domestic use and not for sale.”⁹

Consensus of The Muslim Jurists (*Ijma'*)

18.5 The Muslim jurists have reached *ijma'* among them on the permissibility of the *mudarabah* contract.

19. Appendix 2 Glossary

Terms	Definition
<i>Mudarabah</i> asset	Asset created under a <i>mudarabah</i> venture.
<i>Mudarabah</i> venture	Business or profit generating activities undertaken by <i>mudarib</i> in managing capital provided by <i>rabbul mal</i> .
<i>Mudarib</i>	Entrepreneur of a <i>mudarabah</i> venture.
<i>Mudarib yudarib</i>	<i>Mudarabah</i> contract where <i>rabbul mal</i> invests his capital with a <i>mudarib</i> who subsequently invests the fund with another <i>mudarib</i> .
Profit sharing ratio	The ratio in which the profits are shared between <i>rabbul mal</i> and <i>mudarib</i> .
<i>Rabbul mal</i>	Capital provider.
<i>Tanazul</i>	Waiving of the entitlement to claim.

⁸ Al-Bayhaqi, *Al-Sunan al-Kubra*, v. 6, p. 111.

⁹ Ibn Majah, *Sunan Ibn Majah*, *hadith* no. 2289.