

Prospects of Modarabah financing in Pakistan economy

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Abstract— Modarabah Finance is regarded as the most preferred mode of finance in Islamic economics and finance literature. As this mode has much significance but unfortunately it is not being used in Islamic financial institutions especially on the asset side. In early 80s' the government of Pakistan formulated some specific rules to establish Modaraba as institution but its performance is still questionable that Modaraba as an institution can be flourished in Pakistan or not. As far as Islamic banks are concerned, they also cannot implement this ideal mode of Islamic finance and using other trading modes which have less significance in Islamic finance. A detail analysis of different aspects for it's almost failure is being conducted on the significance scale in this current study.

Keywords- Modarabah, Islamic Finance, Pakistan economy

I. INTRODUCTION

Pakistan banking industry has seen a significant growth in its structure since the time of its inception. With the growth of commercial banks, their services and facilities the need for Islamic modes of finance has also emerged predominantly. In this course of development several institutions and plans were formulated to practically implement different Islamic modes of finance.

Modarabah Finance is regarded as the most preferred mode of finance in Islamic economics and finance. Mudarabah is derived from the word "Al-darb fil ard" means to travel through the land and seeking bounty of Allah. This is related to trade because trade usually involves travelling. Mudaraba Qiraad and Muqaradah terms are used to express a specific business in which the capital is provided by one side (Rab-ul-mal) whereas the labor or work is provided by the other side (Mudarib).

The legitimacy of Mudarabah which is a contract of fidelity has been established on the basis of the Holy Quran, Ahadiths, Ijma and Qiyas. The word "Darb" has been used many times in the Holy Quran whereas the "Daraba" which has literary meaning of set forth, put forward and also journey or travel in the cause of Allah. The Holy Quran says "And others who journey through the earth seeking the bounty of Allah"

The Holy Quran said "Recite, then, of the Quran that which is easy for you. He know that there are sick folk among you, while others travel in the land in search of Allah s' Bounty, and other (still) are fighting for the cause of Allah" (Quran 73.20)

As the Hadith literature is concerned, it seems to be no tradition is quoted in the prominent books of Hadith like Sahih al Bukhari, Sahih al Muslim, Jama Al Tarimzi and Sunnan Al Nisai . However there is a chapter titled as Shirkah and Mudarabah in Sunnan Ibn Maja but it is stated to be weak tradition i.e. means having no authority or Sanad. The mostly quoted incident of commercial contract between Holy Prophet (PBUH) and Hazrat Khadija (RA) has been narrated in many renowned books of Sirah and history but on the critical analysis shows that it was a contract of Mudarabah but of fixed remuneration (Ujrah i.e. labor charges). In fact the said narration gained much popularity that it was quoted by many Sirah writers. The prominent scholars on Islamic banking and economics also have stated it to be a Mudaraba contract.

However, Mudaraba contract can be on the basis of Sunnat-Al Taqrir that means that it was performed in the presence of the Holy Prophet (PBUH) or it was in the knowledge of him but he did not show any condemnation on it and maintain it. So in the pre-Islamic era it was practiced and the Holy Prophet (PBUH) maintained it. However some terms and conditions were added in the light of Islamic teachings and thoroughly discussed by the jurists in the Islamic Jurisprudence (Islamic Fiqh).

Keeping in view the Islamic history and presence of evidence about modarabah practices, we can investigate its practical implications in the contemporary world. Its implications can be specifically analyzed in case oof developing Islamic countries like Pakistan.

The existing literature is mainly on Modaraba in Islamic finance as well as Modarabas in Pakistan in different avenues but none of them discussed it exactly its usage, obstacles and future prospects in the same paper. Hence this research intends to bridge this gap in existing literature in case of Pakistan economy

II. HISTORY OF ISLAMIC FINANCE IN PAKISTAN

With passage of time, different interest free financial institutions have been established in different countries of the world. These institutions have been developed at individual, community and at the government levels.

The main purpose of establishment of such type of institution was to avoid the interest and giving loans to the people having no cost. In initial stage, there were individual efforts in different countries of the world. These efforts were in the form of Baitul Maals, Anjuman (Associations), cooperatives, non banking companies and even in banks but banks avoided the name of Islamic due of unfriendly government in the country. In the time of ascendancy (Khilfah), Baitul Maal were used as economic needs for the people. But due to decline of Muslim powers, Europeans established modern banks working on the basis of interest. But Muslims were not happy with these banks as the need an interest free system because 'Riba' is strictly prohibited in Islamic laws.

Government of Pakistan has also initiated several institutions and schemes to implement an interest free system in different phases of its banking sector development

The council of Islamic Ideology approved eight policy instruments to eliminate Riba from banking sector and profit & loss sharing (PLS) system for the financial sector of Pakistan. Nevertheless it proposed that immense practice of PLS system can harm the economy due to improper institutional setting and business ethics barriers. The council also recommended that other Riba-free policy can be used for the midway period till proper regulatory and institutional setup for PLS banking system. Therefore the council suggested lease-financing which is hybrid of debt and equity . council approved financing-instruments that had normal rate of return comprised of interest¹ Aftermath, the council could not provide the best solution or any framework for elimination of interest from the economy especially from government interest bearing securities, commerce and trade except offering some secondary Riba free instruments.

The State Bank of Pakistan (SBP) was also not interested or sincere in interest free economy even its schemes based on PLS were not truly Shari'ah compliant. The deposits based on PLS were largely invested in the interest-bearing schemes and banks paid almost fixed return to the depositors. In 1985, the State Bank of Pakistan permitted the banks to invest their PLS deposits in government securities based on Riba.

Later on, in 1997, this task was given to International Institute of Islamic Economics (IIIE) by the Commission of Islamization of Economy (CIE) to resolve this deadlock but unfortunately its recommendations were similar as well as non-practicable due to immense socio-economic problems in Pakistan. So, the Model of IIIE also failed to Islamize the economy of Pakistan (Khan, 2003).

The modern banking and financial institutional system has become immensely widen, complicated and their operations

and procedures are inconsistent with the Islamic principles. Since three decades many Muslim scholars are striving to buildup Islamic financial institutions that can do work in accordance with the Islamic principles so that these financial institutions can raise their funds and can invest within the parameters of Islam.

After analyzing the loopholes not covered by different institutions in their efforts in establishing modes of Islamic finance, now question arises about the possible solutions of the issue. In this regard the practice of mudarabah is a considerable effort.

III. MODARABAH; A CLASSIC AND MODERN MODE OF FINANCING

Mudarabah has been defined in Majallat al-Ahkaam al-Adliyah as "Mudarabah is type of Sharikah in which wealth is contributed from one side and labor from the other side" Mudarabah is defined in Mudaraba Ordinance as "A business in which a person participates with his money and another with his effort or skill or both his efforts and skill and shall include Unit Trusts and Mutual fund by whatever name called" whereas "Mudaraba company is a body corporate carrying on Mudaraba business or a company engaged in the business of floating and managing Mudarabah".

In the modern context, Modarabah is the best alternate to Riba. In the modern terminology Modarabah is alike to mutual fund except its non-Shari'ah aspects. Modaraba finance has potential to enhance investment because it has certain features of debt and equity finance. Modaraba can be utilized to enforce financial stability but there are some reasons for its trivial usage by the financial intermediaries.

Although, there is low level of honesty and trustworthiness, poor audit and account system, lack of monitoring businesses and failure of judiciary in case of default by fund users are the major reasons for its unpopularity on asset side or investment side in the existing systems. However Modaraba mode of financing is suitable particularly in financial sector where suppliers of fund (Rab-ul-mal) and entrepreneurs (Mudaribs) interact. Modaraba can be applied in all trading activities of the present time without violating basic principles of Modaraba finance exercised in the past.

As for certificates of Modarabas are concerned in the modern context, there are two situations involved that the assets of Modaraba are liquid or non-liquid. If the assets are liquid then according to Shari'ah it is impermissible except at par or face value because it must be equal in value "exchange money for money". So in this situation it is tantamount to Riba. On the other hand, if the assets are in non-liquid form there is no restriction from Shari'ah perspective for trading in the market because every certificate holder is an owner of its share.

In case Modaraba has both liquid and non-liquid assets, then such Modaraba certificates can be traded unless it is separated. According to Hanafis school of thought if Modaraba is consisted of both liquid and non-liquid assets

¹ Council of Islamic Ideology-CII, p. 15

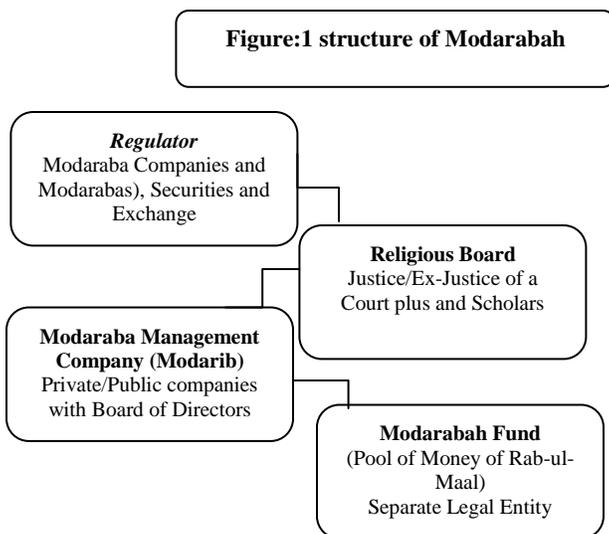
then it can be traded or negotiable. The consensus is that if the non-liquid assets of the Modaraba are more than fifty percent then it can be traded or negotiable in the financial market for raising the funds.

A. Structure of modarabah

In Pakistan the process of Islamization of the economy was initiated in 1977 and in light of the recommendations made by the Islamic Ideology Council, Government of Pakistan introduced certain changes in the Banking Companies Ordinance and promulgated the Modaraba Companies & Modaraba (Floatation & Control) Ordinance, 1980 to provide a legal framework for Islamic financial system. *Units.*

Now modarabah companies are widely operating in Pakistan economy through its different channels. Several registered companies, religious boards and modarabah funds are working currently in Pakistan in its different forms. The structures of modarabah can be outlined through the following figure.

Figure:1 structure of Modarabah



IV. CONCLUSION

Modaraba is an ideal mode of finance and equity finance whereas other modes are of course Islamic permissible but they have secondary significance. Modaraba should be implemented in all Islamic financial institutions but the issue is that the existing system does not allow the Islamic financial system to implement this mode because this mode is based on reliance on the other party or person and there is moral hazard that is the major obstacle in the way of its

implementation. However all the existing Islamic institutions are under compulsion to use other trading modes like Murabaha, Ijarah and Istisna'a etc.

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