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A Critical Analysis of Mudarabah & A New Approach to Equity Financing in Islamic Finance

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Abstract

Financial intermediation serves a valuable purpose, but it can also be structured using equity modes of financing. This can relieve the financee and increase diversity of entrepreneurial undertakings as in debt based commercial financing, there is little room for diversity with obligatory and stipulated servicing of debt. Using Islamic equity modes of financing poses the challenge of the agency problem and moral hazard. The extent of this agency problem in Mudarabah and its impact on economic payoffs between counterparties is analyzed in this study with a simulation model. Based on review of alternate solutions proposed, the author presents two possible covenants which could make Mudarabah mode of financing more acceptable and widely usable in financial intermediation. This would also further the egalitarian objectives of an Islamic economic order.

Keywords: Interest free economy, Islamic Economic System, Mudarabah, Agency Problem, Moral Hazard, Adverse Selection.

1. Introduction

Riba in Islamic Shariah refers to 'Anything paid/charged over and above the principal amount on a loan'. Allah in Quran said "Do not do wrong nor be wronged" (Al Baqarah: 279). It means that interest either results in injustice to the borrower or sometimes, it could result in injustice to the lender. That is why, lending or borrowing and taking or giving interest both are prohibited in Islam.

Furthermore, interest is prohibited due to its discouraging effects on enterprise. If one wants to invest money to earn profit, Islam has allowed trade over lending for interest. If one does not want to invest money for profit, but has some surplus funds, Islam has encouraged spending in charity over lending for interest (Al Baqarah: 276).

Islamic Finance is a growing industry which is constantly evolving and has been competitive to reach and sustain its growth momentum in the midst of even the Great Recession and beyond. Assets of the global Islamic finance industry are estimated to grow to around \$1.6 trillion by 2012 (Source: Reuters). Lately, the Vatican said that banks should look at the rules of Islamic finance to restore confidence amongst their clients at a time of global economic crisis. (Source: Osservatore, March 04, 2009). Some reports suggest that assets held by Islamic financial institutions may rise five-fold to more than \$5 trillion (Source: Moody's Investor Service).

But, Islamic finance industry mostly uses LIBOR linked financial contracts which are akin to debt financing than the more preferable participatory modes of Mudarabah and Musharakah. Usmani (2003) describing the less ideal nature of Murabaha with respect to contributing to the goals of socio-economic redistribution in economy wrote:

“The instruments of leasing and Murabaha are sometimes criticized on the ground that their net result is often the same as the net result of an interest-based borrowing. This criticism is justified to some extent, and that is why, the Shariah supervisory Boards are unanimous on the point that they are not ideal modes of financing and they should be used only in cases of need with full observation of the conditions prescribed by Shariah.” (p. 13)

El-Gamal (2008) criticized current Islamic banking by stating that the primary emphasis in Islamic finance is not on efficiency and fair pricing. Rather, the emphasis is on contract mechanics and certification of Islamicity by “Shariah Supervisory Boards”.

On the structural shortcomings in Islamic banking to avoid commercial risks, Warde (2000) criticized Islamic finance on its inability to avoid 'Islamic moral hazard'; he defined it as unscrupulous behavior on part of those engaged in Islamic finance. This behavior is encouraged by certain features of Islamic finance including the assumption of righteous behavior on the part of employees and customers of Islamic banks resulting in the use of religion as a shield against scrutiny.

2. Problem Statement

Islam prohibits interest, but the practiced Islamic finance contracts link cash flows with an interest based benchmark; hence, there is a need to study whether the preferable equity mode of Mudarabah is usable in Islamic finance and what contractual arrangements could be needed to make it usable.

3. Objectives of the Study

The study sets forth following important objectives:

- To explore how far equity modes could be used in Islamic finance that are not only legal solutions to the prohibition of Riba, but are also in line with Islamic egalitarian philosophy.
- To recommend contractual covenants to solve the principal agent problem and the problem of moral hazard and adverse selection in Mudarabah financing.

4. Importance of the Study

Islamic finance industry mostly uses LIBOR linked financial contracts which are based to debt financing (dayn) than the more preferable participatory modes of Mudarabah and Musharakah. As per the current orthodox understanding and practice of Islamic finance, the often quoted preferable modes like Mudarabah and Musharakah are incapable even in a simple model economy with them as the only mode of financing. Hence, there is a need to examine the reasons for their lack of use and to suggest important changes in their features if the problem lies in contract mechanics.

5. Scope of the Study

The study discusses the problems in preferable Islamic modes of Islamic finance and goes on to discuss the alternate arrangements which could serve as need-fulfillment mechanisms in an Islamic economy.

6. Limits of the Study

Since the preferable modes of Islamic Finance i.e. Musharakah and Mudarabah are not used by Islamic Financial institutions (IFIs), empirical analysis of performance is not possible since they are rarely used. However, since they are regarded as preferable modes by Islamic scholars and are well suited to Islamic egalitarian philosophy, a study on how they can be applied is mandatory.

7. Research Methodology

In this study, extensive literature review on Islamic economics has been done from books, monographs, research articles and reports/bulletins. In discussing the efficacy of proposed changes in plain vanilla equity modes of financing and contractual arrangements, an extensive use of economic theory and analysis through scenario based models has been used to substantiate analysis. Simulation model is used to explain the limitations in current structure of Mudarabah.

8. Critical Analysis of Mudarabah

Mudarabah is considered to be one of the most preferable modes of Islamic Finance both by earlier and contemporary jurists and Islamic scholars. Ibn Taymiyyah observed: "One who deliberates on the basic principles would easily conclude that *Musaqat*, *Muzara'ah* and *Mudarabah* are nearer to justice than hire." (Fatawa, Vol.20. p.356).

Maulana Taqi Usmani (2004) in his book "Introduction to Islamic Finance" stated at least 5 times that Mudarabah and Musharakah are ideal mode of financing respectively on page 12, 17, 72, 107 and 164. His comments on Murabaha which is the most prevalent mode of financing also deserve serious thinking:

"It should never be overlooked that, originally, Murabaha is not a mode of financing. It is only a device to escape from "interest" and not an ideal instrument for carrying out the real economic objectives of Islam. Therefore, this instrument should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where Mudarabah or Musharakah are not practicable." (p. 72)

Khan & Mirakhor (1987) commenting on the preferable nature of Mudarabah commented as follows:

"Even though in practice the role of profit-sharing and partnership is very small at present, they continue to dominate the theory of Islamic banking. They are regarded as the norms towards which practice should and would, eventually gravitate." (p.185-199).

One of the major hurdles in the use of Mudarabah on the asset side of a bank i.e. for financing is that only Rabb-ul-Maal is considered to bear all the financial losses (Shaikh, 2010). Therefore, if an Islamic bank enters into the Mudarabah contract as a Rabb-ul-Maal, only the Islamic bank would have to bear all the losses. Mudarib (Fund manager) bears no loss while he has the complete authority in running the affairs of the business. The Rabb-ul-maal (investor) is not allowed to participate in the affairs of the business (it is unlike the case in VC funds where the Venture Capitalist could include several covenants for dealing with agency problem and even select BoD and BoM and change them accordingly). When a loss occurs, the Mudarib acts like an employee of the business and when the profit occurs, he shares in the profit as if he was the only reason behind the profits.

Bacha (1997) highlighted serious agency problems in Mudarabah and argued that it lacks the bonding effect of debt financing and can induce perverse incentives. Using scenario analysis, he showed that for a 'borrower' faced with the alternative of using Mudarabah, debt or equity financing, Mudarabah would be best in a risk-return framework. For a financier faced with the same three alternatives however, Mudarabah financing would be the worst. Likewise, Khalil et al. (n.d), Dar & Presley (2000), Warde (1999) and Rosly & Zaini (2008) also highlighted the structurally chronic agency problem in Mudarabah.

State Bank of Pakistan in its report 'Financial Stability Review for 2007-08' commented on the issue in following words:

"In fact, the agency problem is one of the major factors for the reluctance on the part of banks to undertake equity based modes of financing, as it gives entrepreneurs the incentive to under-state profits." (p. 7, Chapter 8)

To overcome agency problems, several researchers gave their solutions. Bacha (1997) proposed that the Mudarib must 'reimburse' the Rabb-ul-Maal in the event of certain outcomes. This reimbursement will be in form of the Mudarib giving up part of his equity to the financier. Sarker (n.d) favored incentives for honesty like providing stake in the ownership, linking transfer of ownership through granting bonus shares on the performances, build reserve scheme to induce to hold company shares and provision for profit-related pay linking with the declaration of profits etc. to reduce the agency problem. Central Bank of Malaysia allowed tiered profit sharing structure in Mudarabah (Shariah Parameter Reference 3 for Mudarabah, Bank Negara Malaysia).

Karim (2000) argued that agency problem could be resolved with Mudarib contributing some capital or collateral in the project. Adnan & Muhammad (2008) argued that while cases of negligence of *mudarib* leading to losses are taken care of in *mudarabah*, proper systems should evolve to establish such negligence and ascribe the losses to the *mudarib*. Khan (2003) and Tegani (2003) suggested banks to guarantee investment deposits by 'Tabarru' to minimize agency problem.

Now, we analyze these proposals and see how effective they could be in solving the agency problem in Mudarabah. The proposal by Bacha (1997) is only applicable while the Mudarib is a corporation having its own paid up capital. His proposal tries to solve the problem after it has occurred rather than preventing it beforehand. Another possible problem with this proposal is the fact that market value of shares of the Mudarib's corporation could be anything at the time loss occurs in the joint venture of Mudarabah. Sarker's proposal is also focused on incentivizing than preventing the problem beforehand. It also fails to solve the problem of adverse selection which requires a preventive measure than just incentives. Tier wise profit sharing structure is not completely agreed upon by scholars worldwide.

The problem is in the disparity in payoffs if loss occurs in Mudarabah. In Mudarabah, to be willing to take higher risk, the financier would demand higher returns reflected in demand for higher PSR (Profit Sharing Ratio). But, with higher, PSR, the Mudarib's motivation and incentive diminishes especially if the Mudarib requires bearing no financial losses and already having means of sustenance with another business line.

Now, we present our analysis on the issue. The principle that loss sharing should be based upon and limited to the amount of capital invested is not a condition mentioned in Quran or authentic Hadith. This juristic viewpoint didn't create much problem during early Islamic era when mostly the Mudarib was a poor and resource-less person in financial need with limited incentive and authority to enter in corruption and no capacity to participate in loss sharing if the loss was caused by any reason other than negligence on his part. This could be appreciated by looking at the specific rules in Mudarabah highlighting the rights and duties of Mudarib. Mostly, the Mudarib was a skillful, but a poor and resource-starved person in those times.

In Musharakah, loss participation by all partners across the board is justifiable because all partners are also allowed to work. But, due to the fact that in Mudarabah, the working partner is the sole authority to do the business, making Rabb-ul-Maal completely responsible for sharing all losses is unjustified in the first place.

Consider an Islamic economy with Mudarabah on asset and liability side and there is no other instrument used, Mudarib (usually blue chip companies) with no liability to share loss can obtain financing from banks who would be Rabb-ul-Maal in asset side use of Mudarabah. On liability side, bank will be Mudarib and the small savers and investors will be Rabb-ul-Maal. So, any loss incurred by blue chip companies is ultimately paid by small savers and investors who have all the liability to share losses without having a say in the affairs of the business!

Restricted Mudarabah and clause of willful negligence is insufficient to protect them from losses strictly due to business cycle fluctuations. This example shows that with current structure, even Mudarabah used alone in an economy is insufficient to bring about any egalitarian change.

Let us analyze trust deficit and documentation problems which are cited as reasons why Mudarabah is not being used widely. Relax these assumptions and now consider there is no trust deficit and

documentation problem in the economy. If a loss occurs due to business cycle fluctuations, no part of the loss is borne by the business that had all the authority to run the business. The loss is borne not by the bank as well because bank is Mudarib on liability side. All loss is borne by the small savers and investors. Now consider the government prohibits interest based lending and borrowing too. Will the people want to be Rabb-ul-Maal in Mudarabah with bank or the shareholder in a blue chip company which can take all the money, invest it, earn from it and if loss occurs, pass it onto the small savers! Mudarabah (with current structure) even when assumptions of trust deficit and documentation problems are relaxed and even when there is no competing conventional banking system is ineffective to say the least.

Suppose there is a Company which has established itself with 100% equity investment of Rs 100,000,000. It faces three scenarios in the economy, i.e. Recession, Normal and Expansion. These scenarios have a bearing on the Sales of the company. We assume that Cost of Goods Sold (CoGS) of the Company is 60% of the Sales and its Operating Expenses (OE) are 60% of the Cost of Goods Sold. The Balance Sheet and Income Statement of the Company is presented below. This particular project is named as 'A'. The company also has a plan to invest in another project which is named as 'B' in our example. It has three ways to finance the project 'B'. It could inject more equity, it could issue a bond at 10% rate of interest or it could contact an Islamic Bank and enter into a Mudarabah agreement as Mudarib.

ROE is calculated as Net Profit (NP) divided by Equity multiplied by 100. Since we have not deducted interest expense separately from Operating Expenses (OE), we deduct from NP (Net Profit) the interest expense (Interest Based Liabilities x 10%) and then divide the result by Equity to obtain RoE when debt financing is used.

Project A: Investment: 100 Mln		Income Statement (Recession)		Income Statement (Normal)		Income Statement (Expansion)	
Scenarios		Particular	Rs.	Particular	Rs.	Particular	Rs.
Phase	Sales	Sales	5,000,000	Sales	20,000,000	Sales	50,000,000
Recession	5,000,000	Less: CoGS	3,000,000	Less: CoGS	12,000,000	Less: CoGS	30,000,000
Normal	20,000,000	GP	2,000,000	GP	8,000,000	GP	20,000,000
Expansion	50,000,000	Less: OE	1,800,000	Less: OE	7,200,000	Less: OE	18,000,000
		NP	200,000	NP	800,000	NP	2,000,000
		Balance Sheet (100% Non-Leveraged)		Balance Sheet (100% Non-Leveraged)		Balance Sheet (100% Non-Leveraged)	
		Total Assets	100,000,000	Total Assets	100,000,000	Total Assets	100,000,000
		Liabilities	-	Liabilities	-	Liabilities	-
		Equity	100,000,000	Equity	100,000,000	Equity	100,000,000
		RoE	0.20%	RoE	0.80%	RoE	2.00%

In the example below, first we assume that the Company incurs a loss in all scenarios on Project 'B'. The analysis will show the impact on ROE if the company incurs a loss. Project 'B' requires an investment of Rs 25,000,000. We assume that Cost of Goods Sold (CoGS) of the Company is 60% of the Sales and its Operating Expenses (OE) are 75% of the Cost of Goods Sold. The Consolidated Balance Sheet (combining both projects) and Income Statement of the Company is presented below.

Project B (Investment: 25 Mln)

Scenarios	
Phase	Sales
Recession	1,000,000
Normal	4,000,000
Expansion	10,000,000

Income Statement (Recession) - B	
Particular	Rs.
Sales	1,000,000
Less: CoGS	600,000
GP	400,000
Less: OE	450,000
NP	(50,000)

Income Statement (Normal) - B	
Particular	Rs.
Sales	4,000,000
Less: CoGS	2,400,000
GP	1,600,000
Less: OE	1,800,000
NP	(200,000)

Income Statement (Expansion)	
Particular	Rs.
Sales	10,000,000
Less: CoGS	6,000,000
GP	4,000,000
Less: OE	4,500,000
NP	(500,000)

Project B Financed with Equity

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000
RoE	0.12%

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000
RoE	0.48%

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000
RoE	1.20%

Project B Financed with Debt at 10%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000
RoE	-2.35%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000
RoE	-1.90%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000
RoE	-1.00%

Project B Financed with Mudarabah with PSR = 50%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000
RoE	0.20%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000
RoE	0.80%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000
RoE	2.00%

It could be seen that RoE is higher in all scenarios (Recession, Normal and Expansion) if the company finances project B with Mudarabah financing. Now, we consider what happens if there is a profit in Project 'B' in 3 scenarios i.e. Recession, Normal and Expansion. The example shows that the company will still be having better ROE with Mudarabah if PSR is relatively high. The ROE in Mudarabah with high PSR is comparatively better than ROE in the case when the company issues bonds and also when it issues equity to finance project.

We assume that Cost of Goods Sold (CoGS) of the Company is 60% of the Sales and its Operating Expenses (OE) are 60% of the Cost of Goods Sold. The Consolidated Balance Sheet (combining both projects) and Income Statement of the Company is presented below.

Project B Investment: 25 mln

Scenarios

Phase	Sales
Recession	1,250,000
Normal	2,500,000
Expansion	25,000,000

Income Statement (Recession) - B	
Particular	Rs.
Sales	1,250,000
Less: CoGS	750,000
GP	500,000
Less: OE	450,000
NP	50,000

Income Statement (Normal) - B	
Particular	Rs.
Sales	2,500,000
Less: CoGS	1,500,000
GP	1,000,000
Less: OE	900,000
NP	100,000

Income Statement (Expansion) - B	
Particular	Rs.
Sales	25,000,000
Less: CoGS	15,000,000
GP	10,000,000
Less: OE	9,000,000
NP	1,000,000

Project B Financed with Equity

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000

Consolidated Balance Sheet (100% Equity)	
Total Assets	125,000,000
Liabilities	-
Equity	125,000,000

RoE 0.20%

RoE 0.72%

RoE 2.40%

Project B Financed with Debt at 10%

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Liabilities	25,000,000
Equity	100,000,000

RoE -2.25%

RoE -1.60%

RoE 0.50%

Project B Financed with Mudarabah

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000

Consolidated Balance Sheet (80% Equity)	
Total Assets	125,000,000
Mudarabah Investment	25,000,000
Equity	100,000,000

RoE (PSR=5%) 0.203%

RoE (PSR=5%) 0.805%

RoE (PSR=5%) 2.050%

RoE (PSR=10%) 0.205%

RoE (PSR=10%) 0.810%

RoE (PSR=10%) 2.100%

RoE (PSR=20%) 0.210%

RoE (PSR=20%) 0.820%

RoE (PSR=20%) 2.200%

RoE (PSR=30%) 0.215%

RoE (PSR=30%) 0.830%

RoE (PSR=30%) 2.300%

RoE (PSR=40%) 0.220%

RoE (PSR=40%) 0.840%

RoE (PSR=40%) 2.400%

RoE (PSR=50%) 0.225%

RoE (PSR=50%) 0.850%

RoE (PSR=50%) 2.500%

RoE (PSR=60%) 0.2300%

RoE (PSR=60%) 0.8600%

RoE (PSR=60%) 2.6000%

RoE (PSR=70%) 0.2350%

RoE (PSR=70%) 0.8700%

RoE (PSR=70%) 2.7000%

RoE (PSR=80%) 0.2400%

RoE (PSR=80%) 0.8800%

RoE (PSR=80%) 2.8000%

RoE (PSR=90%) 0.2450%

RoE (PSR=90%) 0.8900%

RoE (PSR=90%) 2.9000%

The above example shows the condition of preference for the company about choosing a particular financing method if it has profit.

Condition of Preference

Debt $(K_d * TD) < (PSR * GP)$

Mudarabah $(K_d * TD) > (PSR * GP)$

The Company will choose equity if its ROE with conventional equity financing is more than ROE in Mudarabah financing. Its ROE will be more in conventional equity financing if PSR is lower. Hence, to be encouraged to finance through Mudarabah, the Company will want higher PSR in Mudarabah. Demand for higher PSR which equates both ROEs could be beneficial for financee, but fruitless for the Islamic Financial Institution since it will get smaller returns with unlimited and exclusive exposure to financial risk. The problem of adverse selection necessitates a preventive mechanism than an incentive mechanism.

With important covenants in place, equity financing can be used and is used widely. It is interesting to study the size of debt and equity market in developing countries. For instance, in Pakistan, corporate bond market hardly exists, whereas equity financing is more prevalent and widely used. Equity financing through shares will forever deny the claims of bankers in general and Islamic bankers in particular who hide behind trust deficit and documentation problems. Why people invest in shares of companies without any guarantee over par value let alone dividend?

In Mudarabah, following two covenants can be introduced.

a) Mudarib can be asked to contribute some capital. The contract will still remain different from Musharakah as only the Mudarib is the working partner.

b) Mudarib can be asked to share in loss to some extent.

These two covenants will minimize the problem of adverse selection, moral hazard and principal-agent conflict.

There is a famous Hadith in this regard which clearly states:

“All the conditions agreed upon by the Muslims are upheld, except a condition which allows what is prohibited or prohibited which lawful.”

It may be argued that these two covenants may violate the principle of **Al-kharaj bil Daman** (Link of exposure to risk i.e. one can claim profit only if one is ready to bear the business risk).

These covenants will not result in violation of the said principle because the proposal is not to transfer all liability to the Mudarib and guarantee profit to the Rabb-ul-Maal. Rabb-ul-Maal will still be liable to bear losses, but Mudarib by way of participation with some capital will also feature in loss sharing. It is unlike the proposal by Khan (2003) and Tegani (2003) who suggested banks to guarantee investment deposits by way of 'Tabarru'.

To structure this model in compliance with principles of Islamic Fiqh, combination of Musharakah and Mudarabah can be used whereby Mudarib in lieu of participation with capital will become a Sharik in the combination. This combination is prevalent in offering liability products and is proposed by Maulana Taqi Usmani (2004, p. 36) for project financing as well.

Infact, it is interesting to study whether the principle of **Al-Khraj bil Dhaman** and **Al-Ghanum bil Gharam** (One is entitled to a gain only if one agrees to bear the responsibility for the loss) are violated in Murabaha and all prevalent Islamic Finance contracts where unilateral undertaking which is binding as well links two sales contracts or one sale and the lease contracts. Masri (2002) argued that unilateral

undertaking must be inadmissible in Sale and lease contracts wherein the unilateral undertaking is taken by the bank before it has possession of the goods.

Islamic banks using Organized Tawarruq to a huge extent use their excess liquidity to provide funds to the conventional banks who by way of this provide interest based loans to people. These suggested covenants must be admissible if we are to move forward in entering the phase of Islamic Finance where we could provide the benefits we once promised.

Conclusion

With important covenants in place, equity financing can be used and is used widely. It is interesting to study the size of debt and equity market in developing countries. For instance, in Pakistan, corporate bond market hardly exists, whereas equity financing is more prevalent and widely used. Equity financing through shares defies the claims of bankers in general and Islamic bankers in particular who hide behind trust deficit and documentation problems. Why people invest in shares of companies without any guarantee over par value let alone dividend and even when the cash inflows are far from sight? Ironically, Islamic values like justice, equality, truth, trust, kindness, honesty and responsibility are often discussed in literature and seminars on Islamic Economics; whereas, in reality, the lack of these values in practice is the major reason why preferable participatory modes remain unusable!

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