

# DAB Bank- Mudarabah Product Guide

## Mudarabah Product Guide

<b>Policy</b>	<b>Person / Function</b>
Accountable Executive	Islamic Banking Division
Policy owner	Head of Islamic Banking Division

Approved by DAB Governor :	Date .....	DAB Board Secretary .....
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# DAB Bank- Mudarabah Product Guide

## 1 INTRODUCTION

### 1.1 PURPOSE

1.1.1 This Mudarabah Product Guide ("the Guide") is an integral part of the overall Shariah Governance Framework ("SGF") developed by the Islamic Banking Division ("the IBD") of Da Afghanistan Bank ("DAB"), the Central Bank of the Islamic Republic of Afghanistan and sets out guidance for the application of Mudarabah contract to various products and services for use by any Islamic Finance Institution ("IFI"), Islamic Window Operation or an Islamic Unit operating in Islamic Republic of Afghanistan collectively referred to as "the Bank" in developing products and services using the Mudarabah contract.

1.1.2 The Guide shall, however, be read in conjunction with other related internal and external policies, manuals and guidelines and specific/general transaction documentation issued by DAB from time to time.

1.1.3 All relevant staff in the Bank are expected to be familiar with the policy and understand their roles and responsibilities with respect to application of the Mudarabah contract to various products and services.

### 1.2 REVIEW AND UPDATE OF POLICY

1.2.1 This Guide shall be reviewed periodically by the Head of the IBD of DAB to ensure that it is in line with the leading industry practices and caters to the customer requirements as well as ensure that the Guide is in line with other applicable changes introduced by DAB and other regulatory authorities.

1.2.2 Amendments to the Guide may be required as a result of one or more of the following reasons (not exhaustive):

- i. Changes in laws and regulations

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- ii. Changes in functions and activities of the Banks in the Islamic Republic of Afghanistan
- iii. Changes in business processes
- iv. Changes in the organizational structure of the Bank
- v. Changes in job roles, duties, and descriptions
- vi. Any other change, where the management deems necessary to update the Bank's policies and procedures
- vii. Any significant modifications arising out of the review shall be recommended by the Head of IBD reviewed by the Supreme Council of DAB and presented to the DAB Shariah Supervisory Board (the "SSB") for their approval.

## 2 OBJECTIVES AND SCOPE OF APPLICATION

### 2.1 OBJECTIVES

2.1.1 The objective of this Guide is to describe the features and the characteristics of the Shariah contract of Mudarabah to be referred to by DAB to assist Banks in developing and offering Shariah compliant products which adopt the underlying Islamic contract of Mudarabah.

2.1.2 The Guide is a framework which shall ensure that the process of product development and product offerings adopting the Mudarabah contract at the Bank is governed by a set of clear guidelines to be adopted by the Bank staff.

2.1.3 The Guide shall outline and communicate the key guidelines for the application of Mudarabah contracts to various products and services. More specifically, the primary objectives of the Guide is to:

- i. Provide concept and legitimacy of the Mudarabah contract under Shariah;
- ii. Provide features of the Mudarabah contract; and
- iii. Provide guidelines on the application of the Mudarabah contract.

### 2.2 SCOPE OF POLICY

The Guide applies to the Bank, its subsidiaries and branches.

## 3 GOVERNANCE AND OVERSIGHT

### 3.1 SUPREME COUNCIL OF DAB

3.1.1 The Supreme Council is the authority for approval of the Guide.

### 3.2 HEAD OF IBD

3.2.1 The Head of IBD is the Guide owner providing, in consultation with the Shariah Supervisory Board ("SSB"), the necessary oversight which shall consider the following:

- i. ensuring the Guide is in line with the current business strategy, governance framework and business structures;
- ii. ensuring that detailed procedures are in place across the Bank to ensure compliance with the Guide;
- iii. assisting in providing subject matter expertise, support and technical guidance to the business in accordance with the Service Level Agreements (SLAs) signed with various departments; and
- iv. communicating the Guide to the business units and concerned functions and ensuring it is understood.

3.2.2 The Head of IBD is consulted on dealing with executive decisions and/or actionable issues arising from the Mudarabah product offerings process and any deficiencies.

### 3.3 ISLAMIC BANKING DIVISION

3.3.1 The IBD is the Accountable Executive (AE) for the Guide with the Head of IBD shall be the policy owner.

3.3.2 The IBD assumes oversight and supervisory responsibilities for the framework used in the Mudarabah product development, offerings process and ultimate responsibility for the ongoing review and for recommending alterations to the Guide.

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- 3.3.3 Any deviations or exceptions to the Guide must be based on a proposal by the IBD and/or other relevant authorised senior management person, in consultation with the SSB, to the Supreme Council of DAB, who shall approve or deliberate on such exceptions periodically. Any material deviation or exception shall be referred to the SSB for guidance or approval.
- 3.3.4 The IBD shall review the Guide's validity, relevance and accuracy as and when needed.

## 4 DEFINITION

- 4.1 *Mudarabah* is also known as *Muqaradah* or *Qirad*. The *Mudarabah* contract is a partnership in profit between one party who contributes capital (*rabb al-mal/capital provider*) and the other party who contributes efforts in the form of managerial/ entrepreneurial skills (*mudarib / manager*). Profit from the outcome of the partnership is shared between the capital provider and manager according to mutually agreed profit sharing ratio whilst losses are borne solely by the capital provider, provided such loss is not due to the manager's negligence or violation of specified conditions.
- 4.2 In the context of business and trade, it means a joint enterprise in which all the partners share the profit according to a mutually agreed upon profit sharing ratio but loss is borne solely by the capital provider/investor.

## 5 LEGITIMACY OF MUDARABAH CONTRACT

The legitimacy of the *Mudarabah* contract is founded on the basis of the *Qur'anic* verses, the *Sunnah* of the Prophet Muhammad (SAW), and the consensus of Muslim Jurists (*Ijma'*).

### 5.1 THE QUR'AN

5.1.1 The following *Qur'anic* verses imply the general permissibility of commercial ventures including *Mudarabah*.

5.1.1.1 "...others travelling through the land, seeking of Allah's bounty; yet others fighting in Allah's cause..." (Al-Muzammil : 20)

5.1.1.2 "And when the Prayer is finished, then may ye disperse through the land, and seek of the Bounty of Allah; and celebrate the Praises of Allah often (and without stint): that ye may prosper." (Al-Jumu'ah : 10)

5.1.2 These verses do not directly address the permissibility of *Mudarabah* but are interpreted to imply *Mudarabah* by referring to those who travel for the purpose of trading and seeking permissible income including those who work with another's capital in exchange for part of the profit.

### 5.2 THE SUNNAH OF THE PROPHET MUHAMMAD (SAW)

#### 5.2.1 The Narration of Ibnu 'Abbas

Ibnu 'Abbas r.a. reported that: "When our leader 'Abbas Ibn 'Abd al-Mutallib gives his property to someone for *Mudarabah*, he stipulates conditions on his partner not to bring the capital across 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 conditions have been brought to the attention of Prophet Muhammad (SAW) and he approved them." (Mu'jam Al-Awsat : Al-Tabrani).

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## 5.2.2 The Narration of Suhayb

Suhayb r.a. reported that the Prophet Muhammad (SAW) said: “Three matters that have the blessing (of Allah): A deferred sale, *muqaradah (mudarabah)*, mixing the wheat with barley for domestic use and not for sale.” (Sunan Ibn Majah).

## 5.2.3 The Tacit Approval of the Prophet Muhammad (SAW)

It has been observed that people were practicing the *Mudarabah* venture since the Prophet's (SAW) first revelation and he did not raise or show any objections against their practice. This is considered a tacit approval by the Prophet Muhammad (SAW).

## 5.3 IJMA'

5.3.1 The Muslim jurists have reached *Ijma'* or a consensus among them upon conducting *Ijtihad* on the permissibility of the *Mudarabah* contract.

5.3.2 It has also been established that the companions of the Prophet Muhammad (SAW) such as Umar, Uthman, Ali, Abdullah Ibn Mas'ud, Abdullah Ibn Umar, Ubaydullah Ibn Umar and A'ishah have placed the property of orphans under the *Mudarabah* contract with no objections from other companions.

## 6 TENETS OF MUDARABAH CONTRACT

6.1 There are a number of features or principles which are attributable to the *Mudarabah* contract. These include nature of contract, capital, management, profit sharing right and treatment of losses.

- (i) **Capital:** ~~Both partners contribute a portion of capital which may not necessarily be equal~~The Rabb al-maal shall provide the entire capital and the Mudarib will provide the labour. The contributed capital can be either in the form of cash or assets with an ascribed monetary value;
- (ii) **Management:** ~~While both partners may undertake the management of the business, if a partner chooses to withdraw from the management to become a sleeping partner, such arrangement is allowed. The partner is also allowed to appoint a third party to manage the business on behalf of the Mudarabah partnership~~The Mudarib shall have full control in the management of the business without the intervention of the Rabb al-maal;
- (iii) **Project / Business Venture:** The project or business must be permissible by Shariah:
- (iv) **Profit Sharing:** The proportion of profit to be distributed between the partners must be mutually pre-agreed based on a Profit Sharing Ratio ("PSR") upon inception of the contract; and
- (v) **Treatment of Loss:** Any losses shall ~~be distributed between the partners according to the capital contribution ratio. However, if the loss is due to the negligence of the managing partner or management team, such losses shall be borne by the respective partner or the management team~~solely be borne by the Rabb al-maal and the Mudarib will lose his effort.

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## 6.2 NATURE OF CONTRACT

- 6.2.1 In general, the *Mudarabah* contract is a non-binding contract which allows any one of the contracting party to terminate the contract unilaterally.
- 6.2.2 Notwithstanding 6.2.1, the contract may not be terminated unilaterally if the manager has commenced the work and when both parties agree not to terminate the contract during a specified time.
- 6.2.3 Notwithstanding 6.2.1, any agreement by both parties on the time frame of the *Mudarabah* venture shall be binding on both parties.

## 6.3 CAPITAL

- 6.3.1 The capital of *Mudarabah* may be in the form of monetary assets or non-monetary asset. As the monetary assets are liquid in character and provide flexibility, capital in the form of non-monetary assets shall be subject to market value or fair value to be determined by third party external experts or at a value to be agreed upon by the partners at the time of conclusion of the contract.
- 6.3.2 Monetary assets of different currencies shall be valued according to an agreed currency of the partnership at the time of signing the *Mudarabah* contract according to the prevailing or current currency exchange rate.
- 6.3.3 Non-monetary capital contributed may be redeemed at its original value invested should it be possible or otherwise at its residual market value upon termination or the expiry of the contract.
- 6.3.4 Debts such as account receivables or loan payables to a capital provider or another party shall not qualify as capital of a *Mudarabah*.

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- 6.3.5 The agreed amount of capital shall be made available to the manager to commence the business activities.
- 6.3.6 The capital may be disbursed in full or partially to the manager at time of execution of contract subject to the agreed terms of the contract.
- 6.3.7 Failure to contribute capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to specified terms and conditions of the contract. The manager has an option to revoke the agreement by returning outstanding capital (if any). Both parties may agree to revise the agreement based on actual capital contribution. Where the Mudarabah expenditure exceeds the actual capital contribution, such liability shall be borne by the capital provider up to the limit of the total amount committed under the contract.
- 6.3.8 Upon liquidation or maturity of the Mudarabah contract, all net assets of the Mudarabah venture after settlement of obligations to third parties shall be used by the manager to return the outstanding capital to the capital provider prior to profit distribution (if any).
- 6.3.9 Any amount due to capital provider under paragraph 6.3.8 including profit (if any) shall be deemed as debt due to the capital provider.
- 6.3.10 The manager in *Mudarabah* shall not guarantee *Mudarabah* capital. However, such capital can be guaranteed by an independent third party who is not related to the manager.
- 6.3.11 The *Mudarabah* third party guarantee can be in the form of performance guarantee of the *Mudarabah* transactions or *Mudarabah* capital itself. For example, capital employed to sell assets or render services may be accompanied by a third party guarantee on payment for such sales and services.

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## 6.4 MANAGEMENT OF MUDARABAH PARTNERSHIP

- 6.4.1 All works and activities undertaken by the manager in relation to the *Mudarabah* capital shall be Shariah compliant.
- 6.4.2 The manager shall have the exclusive right to manage the *Mudarabah* venture. The capital provider shall be precluded from managing the venture even though the capital provider has the right to supervise and monitor the conduct of the manager.
- 6.4.3 The manager shall not be liable for any loss of capital unless such loss is due to the manager's negligence, dishonesty, misconduct or breach of terms of the contract.
- 6.4.4 The powers of the manager shall be provided under the contract terms and conditions which may include the scope and assignment of management of *Mudarabah* capital to a third party.
- 6.4.5 Under the unrestricted *Mudarabah* contract, it does not specify any limiting conditions and the manager is given the discretion provided he acts in the best interests of the capital provider.
- 6.4.6 However, it is permissible for the capital provider to put restrictions on the scope of works of the manager. The scope of the restricted *Mudarabah* contract may specify conditions restricting the manager's role/functions such as determination of location, period for investment, type of project and commingling of funds, provided it does not nullify the purpose/objective of the contract.

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## 6.5 PROFIT SHARING RIGHTS

- 6.5.1 Profit refers to an excess amount after deducting all operating costs, taxes and other related expenses of the partnership which over and above the capital contribution.
- 6.5.2 The profit sharing ratio shall be determined at the time of the signing of contract and may be revised from time to time during the contract subject to mutual agreement.
- 6.5.3 The profit sharing may be based on a ratio or percentage to be agreed upon by all partners.
- 6.5.4 It is not permissible to include a condition in *Mudarabah* contract that stipulates a pre-determined fixed amount of profit to one partner which deprives the profit share of the other partner.
- 6.5.5 Subject to certain conditions, a lump sum amount or fixed amount of profit may be permissible if it does not deprive the other partner from benefiting from, and sharing in, the profit.
- 6.5.6 The profit sharing ratio may be tiered to a target specific profit rate or threshold amount as per a specified benchmark. Thus any profit rate or return that exceeds a specified benchmark may be allocated to the designated partners based on another formula of distribution.
- 6.5.7 Profit promised in the form of a percentage shall not be tied to the capital investment amount. However, an indicative profit rate in a *Mudarabah* contract may be used to benchmark performance.
- 6.5.8 The profit may be measured based on the operating performance of the fund, gains realized from the disposal of ownership rights to the fund or dissolution of the fund.

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- 6.5.9 The profit to be distributed shall be the profit after deducting the operating expenses directly related to the performance of the capital specified in the scope of the agreement.
- 6.5.10 The profit shall be recognized on a realization basis by selling the assets of the *Mudarabah* partnership (*al-tandid al-haqiqi / al-fi'li*) or on a constructive basis (*al-tandid al-hukmi*) by constructive valuation of the assets including accounts receivables.
- 6.5.11 In the case of constructive valuation which is based on market valuation or a third party verification, the constructive profit shall be recorded as a reserve. The reserve from the constructive valuation shall be distributable when gains are realized at the time of disposal.
- 6.5.12 If profit was distributed based on estimated figures, a final consolidation and rationalization shall be undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual profit available for distribution as communicated and agreed upon by the contracting parties.
- 6.5.13 Profit shall be finalized, realized and distributed at an agreed period e.g. quarterly, with mutual consent of the contracting parties.
- 6.5.14 It is not permissible for the manager to guarantee any portion of profit.
- 6.5.15 However, a third party which has no majority ownership or control of the manager can guarantee on profit and/or capital of the *Mudarabah* venture shall be subject to certain conditions and is permissible.
- 6.5.16 Capital contributed by the manager as part of the *Mudarabah* fund shall determine the profit due to or loss suffered by the partner based on the percentage of capital contribution. This is determined prior to profit allocation (if any) to the partner as manager (*mudarib*) of the capital provider fund.

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6.5.17 The manager shall not be permitted to earn a fee in addition to the share of profit in the *Mudarabah* contract. However, an independent and separate agreement may be constructed between the manager and the capital provider assigning the manager to perform a business activity that is not, by custom, part of *Mudarabah* operation for a fee. The independence of this separate agreement shall mean that if the contract providing this activity is terminated, it shall not affect the *Mudarabah* contract.

## 6.6 LOSS LIABILITIES

6.6.1 Loss shall be recognized when the liability exceeds the value of the assets at a point in time from a balance sheet perspective. Alternatively, when expenses exceed revenue for a defined period, an operating loss shall be recorded. *Mudarabah* operating loss which is measured during the operating period may be offset against prior or future profits.

6.6.2 Loss shall be solely borne by the capital provider except in the event of misconduct, negligence or breach of contract by the manager.

6.6.3 It is permissible for a partner to agree, without any prior condition, to undertake the responsibility of bearing the loss at the time such loss is realized.

6.6.4 A third party may undertake to bear the loss of capital due to misconduct or negligence on the part of the manager.

6.6.5 The capital provider may take any collateral from the *mudarib*, provided that the collateral could only be liquidated in the event of negligence or misconduct or breach of term of contract by the *mudarib*.

6.6.6 Capital loss shall be recognized when the loss occurs prior to the commencement of the business or extenuating circumstances beyond the

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control of the manager but not due to the negligence or misconduct of the manager.

6.6.7 The *Mudarabah* agreement may be reviewed to ascertain whether the loss impairs the future performance of the business activity and the partners may decide to restructure the agreement accordingly.

6.6.8 Operating loss shall be recognized when the loss occurs during the course of ordinary business and the losses may be carried forward to the next period or set off against prior period profits.

## **6.7 OTHER OPERATIONAL MATTERS OF MUDARABAH**

### **6.7.1 ORIGINATION AND EXECUTION OF MUDARABAH CONTRACT**

6.7.1.1 A *Mudarabah* agreement shall include the definition of the general contractual framework; the intention of the parties on restrictions on the contract or otherwise; the intention of the parties on having either a revolving transaction or separate transactions; the profit sharing arrangement; and types of guarantees or collaterals involved in the contract in the event of loss due to misconduct, negligence and breach of contract.

6.7.1.2 A business venture of *Mudarabah* may be in various sectors including but not limited to trading, plantation, construction, manufacturing, investment and services.

6.7.1.3 Investment in activities which may in extenuating circumstances become non-approved activities shall require purification of the non-compliant income from such activities including any gain from disposal of the investments.

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## 6.7.2 TERMINATION OF MUDARABAH CONTRACT

6.7.2.1 In general, the *Mudarabah* contract may be terminated due to the following considerations:

- a) Unilateral termination by any of the parties in the event of a non-binding contract.
- b) Mutual agreement to terminate between the parties.
- c) The contract expires as at the maturity date agreed by the parties.
- d) The impairment of the *Mudarabah* fund does not favour the continuity of the venture.
- e) The demise of the manager or the liquidation of the managing institution.
- f) The non-fulfilment of one of the conditions that would consequently render a *Mudarabah* contract valid. In this case, the *Mudarib* is deemed as the worker/agent who deserves fair and reasonable wages or fees only.
- g) The Court may issue an order to end a *Mudarabah* contract on any reason that the Court deems fit either upon the request of one or all the partners or by request of certain authorities.

6.7.2.2 On the maturity or liquidation date of the *Mudarabah* partnership, the assets shall be liquidated in the manner specify in Clause 6.3.8.

## 7. CUSTODIAN OF THE DOCUMENT

This Product Guide shall be under the safe custody of the Islamic Banking Division ("IBD") of DAB. Any changes to this Manual shall be made by the IBD with prior consultation with the SSB, as reviewed by the DAB Executive Board and upon approval by DAB Supreme Council. A copy of the amended Guide shall be made available to all stakeholders and SSB members for reference and implementation.

## 8. EFFECTIVE DATE OF THE DOCUMENT

The Effective date of this guide is the \_\_\_\_\_ day of \_\_\_\_\_ 20\_\_\_\_