

## **Practical Challenges of Mudarabah Deposit in Islamic Financial Institutions in Sri Lanka**

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**Abstract:** All products and services in Islamic Financial Institutions are structured with the support of Shariah compliant commercial contracts. Accordingly, deposit accounts in IFIs are also being backed by Shariah contracts such as Qard, Wadiah, and Mudarabah. These are contracts suggested by the scholars with some Shariah compliant modification to have similar attributes of conventional deposits. Thus, IFIs have to practice according to Islamic commercial law as well as competitive to its conventional counterpart. This study intended to identify the practical challenges faced by IFIs with respect to Mudaraba deposits. The qualitative research method has been employed in this survey. Primary data were gathered through interview and the secondary data were gathered from available library sources. Three Islamic finance institutions were chosen as sample, each representing a different types Islamic financial institution in Sri Lanka. The study found that Islamic financial institutions face certain challenges while applying Mudaraba contract to deposit such as Rate issue, CBSL restrictions and rules, lack of awareness about the products from both customers and staff, lack of technologies, Non-compliant deposit fund and the like.

**Key words:** Islamic banking, Islamic finance, Mudarabah deposit, PSR

### **Introduction**

Islamic finance is one of the growing industries all over the world which is consists of banking services, financial services, capital market service, Takaful and the like. Mudharabah is the basic products in Islamic banks and nowadays it is the main way used to fund mobilization for all Islamic financial institution. And it provides a big contribution for social-economic development through providing an opportunity not only to the rich people but also to the middle-class people to save their surplus for building their future. (Afzadu-ur-Rahman, 1990) Islamic financial system is an alternative way in the conventional financial system. In Sri Lanka, Islamic finance has been established by the inception of Amana investment in 1997.

Currently, there are sixteen Islamic financial institutions (IFIs) in practice including banks, finance companies and Takaful companies (S.Nathira Jahan, 2018). In Sri Lanka, the Islamic banking system is running parallelly with the conventional banking system. Islamic banking is should comply with Shariah rules and regulation in all its operations. Islam prohibits interest (riba) in all commercial transaction. Islamic banking services are based on profit and loss sharing whereby it does not accept paying and getting interested. In this regard, Islamic banks accept deposits based on profit sharing (Mudharabah). Mudharabah is an agreement between the customer (Rabb Al-Mal) and the bank (Mudarib) whereby the Rabb al-mal provides capital to be managed by the mudarib. And they will share the profits according to the mutually agreed profit-sharing ratio. Accordingly, Mudarabah is being used by IFIs to offer Islamic deposits products such as a saving, investment, project financing, working capital, financing and Mudarabah Sukuk (S. Nathira Jahan 2018).

### **Research objectives**

This research is going to discuss the Mudharabah deposit to identify the issues and challenges.

### **Research problem**

In general, it is known that the conventional banking system depends on interest. They paid and received interest for every deposits and loan advanced to the customers. Interest is strictly prohibited in Islam, and therefore, alternative contracts were formatted by fulfilling the Shariah objectives. Such as Mudharbah, Musharakah, Ijara, and Salam and the like. Among these contracts, Mudharabah is widely used for offering deposits. However, there are ongoing arguments that whether the Mudharabah based deposits have all the characteristics of deposits account as conventional banks. Accordingly, the following challenges explained theoretical and practical related challenges.

(S. Nathira Jahan, A.K.F. Rakshana, H.M. Ahamed Hilmy, 2018) the status that there were five issues identified. There is Rate of return risk, Credit risk, equity investment risk, marketing risk, multiple contracts in a single contract. And also

It is the general perception of the public, Mudarabah expedition not enough (S.M. Mohamed Nafees, Mohammad Hassan Ahamad and Ahmad Masum, 2018).

Lack of awareness of the practice of Mudarabah among the people could lead to hiding the Mudharaba issues (T.M. Rimsan, 2012).

Therefore, the Islamic bank faces various issues and challenges while implementing the Mudharaba deposits. However, the Mudharaba account continues to be used by the people and its problems and challenges are largely ignored. Spite the above problems, there is no in-depth research has been done on this issue in Sri Lanka. Therefore, this research conducted to identify challenges and issues that may arise during the Mudharaba deposits in Sri Lanka.

### **Methodology**

Data analysis is based on the qualitative method. The researcher gathers primary and secondary sources to achieve the objectives. To achieve the research objectives mentioned above the study has used secondary data collected from the literature. Such as previous journal publications, books and book chapters, authorized or recognized web site information and the like. Primary data will be collected through interviews, which are senior managers, shariah advisors and shariah board members of selected each IFI's.

The sample consists of three various Islamic financial institutions. They are fully fledged Islamic bank (Amana bank), Leasing Company (LOLC Al-Falaah) and Islamic window of the conventional bank (Al-Najah) in researcher area. The interview was conducted directly by the analyst and the data collected by phone was compiled. The researcher compiled 12 questions to interview the interviewer and interviewed 15 respondents in sample selection of this study. They are Shariah advisors, SSB members, Deposit managements, Product developers, and Branch managers.

### **Literature review**

This chapter was reviewing the literature on Mudarabah deposits products in IFI's. This chapter is important in widening the knowledge of the researcher on Mudarabah in IFI's to develop the research questions. For this study, the researcher has reviewed various research publications and other useful data to get the proper understanding of the concept. A Review of the existing literature used for this study is briefed as follows.

In the previous studies further, research conducted by S. Nathira Jahan, A.K.F. Rakshana, H.M. Ahmed Hilmy, (2018) according to this study has found five main challenges in the practice of Mudharabah deposits.

Further, another study conducted by S. Issath Nimsith, MNM. Nusrathullah, HMM. Haleem, (2019) the main purpose of the research work is to explore and pinpoint some marketing strategy issues which can be helpful for new investors and old stakeholders in the sector of

Islamic banking in Sri Lanka to penetrate the market successfully. And also, the aim of the study is that how Islamic banking can grow in an environment where the conventional banking sector has deep roots.

Further another study conducted by S.M. Nafees and M.T. Habeebullah, (2016) according to the study proposes various instruments based on respective concepts to expand the application of Islamic banking products. Similarly, litigation has many disadvantages such as delay, cost, loss of privacy and prejudice to the business relationship.

Mudarabah is the most basic commodity in Islamic banking, and it is now the predominant tool for all Islamic financial institutions to collect funds. It also makes a major contribution to social economic growth by enabling not only the wealthy but also the middle class to save their surplus for the future. (Afzalu -ur-Rahman, 1990).

Mudarabah is an ancient type of business organization that has been approved by the Islamic Shariah. The principle of replacing interest with profit sharing in the depositor bank and bank business relationship, which was first introduced in the 1950s and 1960s, has now gained widespread acceptance (ML. Weitzman, 1984)

Mudharabah is the basic products in Islamic banks and nowadays it is the main way used to fund mobilization for all Islamic financial institution. And it provides a big contribution for social-economic development through providing an opportunity not only to the rich people but also to the middle-class people to save their surplus for building their future. (Afzadu-ur-Rahman, 1990)

In the study done by Siti Noor Aini and Hassilah (2012) on the principle of Mudharabah, the elements of uncertainty and speculation that exist in the conventional derivatives can be avoided. According to them, in conventional derivatives, the investors do not need to know in detail the business involved and they only get their share of the benefits at the end of the maturity period. This situation demonstrates the element of injustice because it involves gharar (uncertainty) as the entrepreneur's practices are questionable, whether the business is conducted in the right manner or otherwise. Therefore, the author suggested that the principle of conventional options in derivatives be converted to Mudharabah principles.

According to Erni Susana and Annisa Prasetyani Erni (2011), the Mudharabah funding by PT. Bank Muamalat Indonesia is Shariah compliant. The guarantee provided by the bank to the entrepreneur is allowed according to the Fatwas of National Shariah Board (DSN), Indonesian

Ulama Council (MUI) 2003. In addition, the financing decision was based on the 6Cs (character, capacity, capital, collateral, condition of economy, constraints). The usage of Mudharabah financing in all sectors of the economy can provide benefits and prohibits business that contains non-halal elements. Therefore, various researchers have identified a number of challenges and arguments regard about mudharabah deposits.

Based on the analysis of data gathered, this study has found the following challenges in the mudarabah deposit in IFI's. These identified challenges also put forwarded by the respondents from her own ideas and experience as well as from the expert opinions from the past literature.

### **1. Rate issue**

According to the interviewee, the conventional bank agreed fixed rate but the Islamic bank shares the profit based on the profit-sharing ratio. The Mudarabah deposit customer gets the high satisfaction compared to the conventional bank customer. In conventional site, the customer agreed to the bank to 10%. The bank gets to the bank's specified return after that the bank should give the 10% fixed return. However, the bank did not get to the specified return the bank should give to the customer's 10% rate bank's own money which is one of the risks in the conventional bank site. In the Mudarabah deposit, they agreed on a profit-sharing ratio, therefore the Islamic bank gets to the return and shares to the return under the PSR system. This return may come highly return compared to the conventional bank customer's fixed return rate.

### **2. Non- Muslims deposit**

Islamic banks followed the concept of halal, in which banks should be managing the customer's fund under the shariah concept. The Non-Muslim customers deposit their money in the bank. They should be an analysis of the way of money of the customers under the KYC (to know your customer) system which is the system of CBSL's rule to non-Muslims money analysis. But there is not an issue to the conventional bank and another Islamic window. However, this is a critical shariah issue in the sample 1.

### **3. Customer`s argument**

The customer compared to the rate with conventional rate, the argument indicates conventional banks rate higher than Islamic bank, which is the major challenge in the IFI's. So, bank

describes it as an Islamic bank, in order to this case they can't be fixed return. A fixed return is not permitted under the Mudarabah deposit.

#### **4. Can't use restricted Mudarabah**

Sample 1 follows unrestricted Mudarabah deposit due to practical issue. They can't use restricted Mudarabah deposit. According to the country context in case of loss in the restricted business the bank may face challenges in sharing profit and the bearing loss.

#### **5. CBSL guideline**

The general rule of the central bank is customer's fund should be secured. So, the Islamic banks and other Islamic window used the unrestricted Mudarabah. customer's fund did not secure in the central bank auditing time the central bank cancelled to the IFT's license. Accordingly, it is also a challenge of the Mudarabah deposit. The central bank's rate is very important to every bank and IFT's. The CBSL defines the rate of return the IFT's will be given to the return specify a rate. But the shariah rule is can't be fixed the rate of return. It is a contemporary issue in the shariah.

#### **6. Customer's concern**

Customer's mentality attracts the conventional banking system, which is Customers wise common view conventional bank is a government bank. But sample 1 is a private bank. It is also a major issue in the IFIs.

#### **7. High risk in Mudarabah**

A high-risk situation has been established. Low-risk products are preferred by banks; the lower the risk, the better. Banks, on the other hand, classify Mudarabah as high-risk items. As a Rabbul Mal (capital provider) or Musharik bank, Islamic banks will face a variety of risks (partnership). However, three threats can have a significant effect on an Islamic bank's decision to incorporate PLS in their financing: financial risk, market risk, and rate of return risk.

Islamic banks are very cautious in providing finance because the money would most likely come from depositors who put their money in Islamic banks. They anticipate that their deposit money will be secure. If something goes wrong in the future, Islamic banks must bear the loss and replace depositors' funds.

Banks do not want to share losses; instead, they just want to share profits. To put it another way, they want something that can reduce losses while increasing income. The majority of Mudararib will have enough and more knowledge about the project in Mudarabah, while Islamic Banks will not have access to the project's profitability. As a result, there will be a misunderstanding between the two sides (Sapuan, 2016). To avoid any losses, Islamic banks must perform a thorough screening, monitoring, and analysis, as well as exercise caution while conducting the project. To prevent any false information, information from the beginning of the process until the end must be disclosed and clear.

### **8. Credit risk**

Savings account credit risk is rarely encountered by traditional financial institutions. However, there is a high chance of credit risk in an IFI's Mudharabah savings account. Since the actual benefit and company IFIs are involved are not transparent, the consumer is unable to obtain adequate details. Furthermore, consumers as fund providers must bear the loss that occurred due to the IFIs' incompetence as business partners. However, there is no straightforward method to assess the Mudharib's negligence.

### **9. Equity investment risk**

Investing in Mudharabah exposes Islamic banks to greater risk because it is a profit-sharing investment. Since Mudharabah is subject to lose capital even if there is adequate supervision, Islamic banks must recognize the funding risk of equity-based on assets and the possibility of losing capital if the company makes any losses. In short, Islamic banks should exercise caution when selecting projects to minimize any possible investment losses.

### **10. Marketing risk**

Other than the fixed rate of return, traditional financial institutions deliver enticing gifts and promotions. IFI's, like its competitors, advertises various forms of gifts for saving account holders in their brochures and official websites, such as gifts for students and New Year promotions. Other than the negotiated profit ratio in the contract, how is these extra benefits considered in Sharia? Is this permissible in Islam? IFI is responsible for resolving these problems.

### **11. Profit equalization**

One of the latest issues is profit equalization, the distribution is given the rate by the central bank for a specific month which is one of the issues in the shariah is the cost. The benefit from the Mudarabah deposit is shared according to the profit-sharing ratio. However, under the Mudarabah deal, for example, the bank agreed to a 10% share. Therefore, CBSL has set a rate of 8% for the defined rate. Apart from the central bank guideline, sample 2 was giving to the rate at the time. Sample 2 on the other hand, decided that the Mudarabah deposit would provide the 10% share. Sample 2 on the other hand, will hold the 2% reserve. This 2% return is distributed to the consumer through Sample 2, the 2% return was not used by the bank. The same return, on the other hand, goes to a specific.

## **12. Lack of awareness among the people**

And another challenge is lack of awareness among the people. They did not understand the Islamic banking system. So, People should get awareness and get the knowledge of the Islamic bank.

## **13. Staff's lack of knowledge**

Another one is knowledge gap to staff; it is a one of the challenges in the IFIs. The staff didn't understand the Mudarabah deposit concept and Islamic banking system. However, the bank provides awareness program to the staff.

## **14. Argument of cross and net profit**

Another challenge of argument of the cross profit and net profit. The Mudarib give to the effort and time to the work. So, the bank is distributing the fund in the cross profit.

## **15. Bankruptcy**

The bank faced bankruptcy in that situation bank will face shariah issue, because, bank will be face bankruptcy, the bank should give to the customer`s capital. This is a major issue is capital distribution.

## **16. Customers adopted to the traditional banking system**

Practically the people adopted to the conventional banking system while more people open their account under the conventional banking system. They think it is trust for their capital or investment the challenge also kind of the issue in sample 3.



## **17. Technical issue**

Technical issue is the challenge in the bank site. The customer expects their return should come on time. But some time customer's return will become delay for the technical issue.

In general, when comparing the challenges faced by these three Islamic financial institutions, three samples were faced the same challenges together as Rate issue, CBSL fixed rate return, Technical issue and People`s lack of awareness. And two Islamic financial institutions such as sample1 and al sample 2 were faced the consensual challenges of PSR gap and Non- Muslims deposits. In addition, both sample 1 and sample 3 identified the challenge customers concern. And also, sample 2 and sample 3 faced consensual challenge is lack of knowledge of staff. When looking at the individual challenges faced by banks such as sample1, sample 2 and sample 3. Sample 1 also addresses challenges such as High risk, Credit risk, Marketing risk, Equity risk and can`t use restricted Mudarabah. And sample 3 faces challenges such as Bankruptcy, People adopted conventional banking system, did not have separate shariah advisor and did not have separate product developer. Therefore, the researcher has identified the challenges faced by Mudarabah deposit in Islamic finance institutions in Sri Lanka.

## **Conclusion and Recommendations**

According the objectives of this study, the study has identified the challenges of mudarabah deposit in IFT`s. Qualitative method has been used to conduct this survey. Further this study has found Rate issue, Restricted mudarabah, CBSL fixed rate return, Customers argument, People`s lack of awareness, Non-muslims deposits, PSR gap and the like. The following appropriate recommendations were given from researcher`s point of view:

- For this analysis, only three IFI`s were chosen. So, future researchers should consider other Islamic financial institutions.
- Future research could broaden the reach of the study by including more Islamic banks and extending coverage to the entire island
- In order to support the study's goals, future studies will want to explore potential cooperation with industry professionals, such as regulators and Islamic banking players. The help from the established to the challenges of Mudarabah deposit in IFI's in this study or other related studies.

- In addition to retail depositors, future studies will want to expand the sample to include other categories of depositors, such as government agencies and businesses.
- The study's findings could include comparative results, such as the difficulties of mudarabah deposits in banks.
- In order to look at the bank's actual operations, future studies will want to consider parallel time-series data analysis in addition to the survey questionnaire. Rates of return, for example. The time-series data analysis could be condensed to suit the survey's target respondents.
- Future researchers can conduct the study about customer's awareness.
- Finally, if a proper semi-structured interview with an industry expert can be conducted concurrently in order to gain some specific input and feedback on the subject matter, a similar field of research can be very useful.