

ISLAMIC CONCEPT OF MUDHARABAH AND ITS PRACTICE IN ISLAMIC BANKING

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Abstract

"It is a quality of Islam that talks and teaches for all walks of life in clear, logical and practical manner. Similarly the chapter of Islamic economics is much defined, vast and categorical. Islam categorically prohibited Riba but advised the business modes shirkat, mudarabah, qard-e-hasna etc. For about last fifty years ago Islamic banking was experienced. And now many Muslim countries are benefiting from Islamic banking and offering different mode of financing among those, one is Mudarabha. This research paper deals to understand the real spirit of mudarabaha and its compatibility with recent practice of mudarabha in Islamic banking. In this, merit and demerits are also discussed."

Introduction

Mudarbah is financial contract which has been a voyage among the Arabs since before the advent of Islam. It is used to be a two party contract. In modern context, it has developed to be a mode of financing as an alternate to *riba* in financial institutions. The Islamic banks and financial institutions have also involved themselves into the composition of Mudarabaha. Profit sharing principle (PSP) is based on mudarbah principle, i.e. profit will be share between the owner of the capital and entrepreneur on the basis of contractual agreement where as losses under normal circumstances would be written on capital.

Islam categorically prohibited to Riba which is foundation of conventional banking. Therefore many World Muslim countries made the law to eliminate riba i.e Kuwait, Saudi Arabia, Pakistan, Iran,

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Sudan and Malaysia etc. Pakistan is also among those three countries; they made efforts and decided to established interest free economy and Islamic banks. Mudarbah is an important pillar in the recent Islamic banking system.

Before to discuss the practice of Mudarbaha in Islamic banking; the study of Islamic concept of Mudarbaha is essential.

Definition

The word “Mudharbha” comes from the word “Dhrabha”(حَمْرَب). One meaning of “Dhrabha” is beating while if it comes with *Sala* then its means to walk. Another meaning is to strive and travel on the earth in searching for the Rizque or for commercial ventures to make profits.¹

Likewise Allah Says in the Surah Muzzammil that “Yadhrbona fil Ardi” (يَضْرِبُونَ فِي الْأَرْضِ) means others travelling through the land, Seeking of God's bounty.² Imam Ashokafi defines the Mudharbha in Nayl al Autar (نيل الاوطار) that the term Mudharbah refers to the travel on earth, this travelling is an activity of striving, struggling and hardworking, therefore the partner who works on capital, travel and walk on earth.³ In Sunan Abu Dawud, a Hadith of Prophet (PBUH) narrated by Abu Hurayra(رضي الله عنه):

“The Apostle of Allah (peace_be_upon_him) having said: Allah, Most High, says: "I make a third with two partners as long as one of them does not cheat the other, but when he cheats him, I depart from them."⁴

As Al-Marghinani writes in a Classical Manual of Hanafi Law “Al-Hidayah” that in Mudharbha one partner invest the capital while other partner through his striving and struggling; wants to get more money in the form of profit that’s why this matter is called Mudharbha(مضاربه).⁵

Some jurists call ‘Mudarabah’ a partnership contract because both the Mudarib and Darib participate in sharing profits, but some others call it an agency contract between the principal (Mudarib) and the agent (Darib) because the entire loss is borne by the principal. As Imam Raghif As Fahani that the Mudharbha is such a trading Sharakat, in which ones invests while second works and then both will share the profit or loss.⁶ Similarly in “Al-Hidayah” stated that Mudharbha is such a matter in which Sharakat is happened; among both one is being

shared due to his capital while second is being shared due to his hardship and the profit is being shared among both.⁷ In Fatawa-e-Alamgeeri, such contract is called *Mudarbha* in which ones invest and second works then profit is shared by both. If ones invest and second works but the profit is not shared with this condition that the profit will of investor then it is *Badaat* and if all profit will be of a Mudrib (who works) it is purely a loan. Therefore with the second situation (loan) the responsibility of profit and loss is on whom who gets capital as loan.⁸

In conclusion the speculative partnership refers to one person giving a certain fixed amount to another person in order to trade with it. The profit of it would be distributed between them both according to what they have agreed upon. However, if any loss occurs, it will be born only by investor of the capital money. As for the employee, it is enough for him to lose his effort and striving, so why should another loss be imposed upon him?

Mudharbha in Islam

The people of Medina called this a form of business as ‘Muqaradah’ which is derived from the Arabic word ‘Qard’. ‘Qard’ means loan which signifies surrender of right over capital by the owner to the user. The Muqaradah is also called Qirad. In period of ignorant such matter of Mudharbha was familiar with “Qarraz”, and the same business matter was remained continued by the Prophet Muhammad (PBUH) and Muslim as well as maintained in their practices. If there would any objection on it, surely it was stopped even the business deal of Hazarat Muhammad (PBUH) between Hazrat Kadija (R) was the matter of “Qarraz”.⁹

In the Islamic period the very first example for the matter of “Qarraz” (قراض) was the event of sons of Hazarat Umer (R), this event is also recorded in Al-Muwatta by Imam Malik that Abdullah and Ubaydullah, the two sons of “Umar bin Al-Khattab (رضي الله عنه)”, passed by Abu Musa Al-Ash’ari (رضي الله عنه) in Al-Basrah. So he gave them some wealth to take to Hazrat Umar. Then he encouraged them to take some merchandise with it that they could sell, and then when they sold it, they could pay the capital sum of the money to Umar. Thus they did so. However, Umar forbade them from keeping the profit. So Ubaydullah said to him, “Couldn’t you make this a speculative deal, since he (Abu Musa) said, “If this wealth decrease or is used up in

loss, then we are responsible for that.” So Umar took the capital sum of money and divided the profit in half, giving them each of the remaining profit. Thus he made it a speculative deal.¹⁰

Hazrat Muhammad (ﷺ) was the Law-maker, and during his presence, he learnt the Muslims for the matters of all walks of life such as the economical matters i.e. Sharakat and Mudarbha. Decidedly those practices of Sharkat and Mudarbha which were done in lifetime of Hazrat Muhammad (PBUH), he permitted those. And there are many examples of said mode of financing, which are reported at that time such as:

1. It is reported that a man come to Muhammad (PBUH) and said that I do business in the market and my partner offers salat in the mosque. Prophet (PBUH) said blessing of your business is due to him.¹¹
2. Another saying by the Holy Prophet (PBUH) that a person who gives brought up to his three daughters nicely, he is likely to be a prisoner. Therefore, O the people of Allah do the business of Mudarbha with him or lend him.¹²
3. The uncle of Prophet (PBUH), Hazrat Abbas (R) did the Mudarbha with some conditions and when it was come to the knowledge of Prophet (PBUH), he liked it.¹³
4. One Companion of Prophet (PBUH) named Hakeem Bin Hizam (R) did the Mudarbha on the same conditions which were practiced by Hazrat Abbas (R).¹⁴
5. Al-Marghinani, writes in Al-Hidayah that the companions of the Prophet (PBUH) did the business of Mudarbha.¹⁵
6. A Saying of Prophet (PBUH), narrated Urwah ibn AbulJa'd al-Bariqi that, the Prophet (peace_be_upon_him) gave him a dinar to buy a sacrificial animal or a sheep. He bought two sheep, sold one of them for a dinar, and brought him a sheep and dinar. So he invoked a blessing on him in his business dealing, and he was such that if had he bought dust he would have made a profit from it.¹⁶
7. Hadith narrated Hakim ibn Hizam, the Apostle of Allah (peace_be_upon_him) sent with him a dinar to buy a sacrificial animal for him. He bought a sheep for a dinar, sold it for two and then returned and bought a sacrificial animal for a dinar for him and brought the (extra) dinar to the Prophet

- (peace_be_upon_him). The Prophet (peace_be_upon_him) gave it as alms (sadaqah) and invoked blessing on him in his trading.¹⁷
8. Hadith narrated Jabir ibn Abdullah, the Prophet (peace_be_upon_him) owed me a debt and gave me something extra when he paid it.¹⁸
 9. Hadith narrated Abu Hurayrah, the Apostle of Allah (peace_be_upon_him) having said: Allah, Most High, says: "I make a third with two partners as long as one of them does not cheat the other, but when he cheats him, I depart from them."¹⁹
 10. Hadith narrated by Hazrat Sohaib (R), the Holy prophet (PBUH) said that the blessing is in three things, among one is to do Mudarbha.²⁰

It appears that business sort of Mudarabha was practiced in the life of Muhammad (PBUH) & early Islamic Period but it is legislated from Consensus later. And it is the Consensus of all Muslim that the matter of Mudarabha is legal. Likewise there many evidences from the life of companions of the Holy Prophet (PBUH) that also support to legislate the Mudarabha, such as:

Hazrat Usman (R) practiced it²¹, Hazrat Qasim Bin Muhammd (R) reported that our some money was deposited at Hazrat Aysha (R), that she was provided for Mudarabha.²² Hazrat Umer did Mudarabha with Zaid Bin Kaleeda. And also started the Mudarabha from Bait ul Mal, even it is reported that he used to give the wealth of orphans on the principles of Mudarabha.²³, a companion of Prophet (PBUH), Hazart Jabir (R) opinioned that there is no harm inn Mudarabha.²⁴, It is reported about one companion of Prophet (PBUH), Hakeem bin Hazam that whenever he invest his capital for Mudarabha, and lay down also some conditions for the security of business.²⁵

In the light of above reports and facts, it can be concluded that Mudarabha is as mode of financing is lawful.

Elements of Mudarbha

Elements of Mudarabha means on which the contract is to be made. Offer & acceptance of the matter or contract are described as the while of Mudarabha in Al Hidayah and Drmukhttra.²⁶ Similarly these are described as element in Fataw-e-Aalamgeeri.²⁷ About five elements are described as elements of Mudarabha in the Kitab ul Fiqh Alil Mazahib ul Araba which are these:

- i) Owner of Capital. (Rab ul Maal)
- ii) Capital that is to be invested. (Ra'asul Maal)
- iii) Person, who will work on capital. (Mudarib)

- iv) Offer of contract for business.
- v) Acceptance of contract.²⁸

Types of Mudarbha

There are two types of Mudarabah namely:

Al Mudarabah Al Muqayyadah

Rab-ul-Maal may specify a particular business or a particular place for the *mudarib*, in which case he shall invest the money on some conditions such as:

That money will be utilized in a particular place or city.

That money will be given only for one or two years.

That money will be invested in that particular business like in the business of textile not other than.

This is called Al Mudarabah Al Muqayyadah (restricted Mudarabah).²⁹ Likewise the companions of the Holy Prophet (PBUH) did also the business of Mudarbha on some particular grounds.

Al Mudarabah Al Mutlaqah

However if Rab-ul-maal gives full freedom to Mudarib to undertake whatever business he deems fit, this is called Al Mudarabah Al Mutlaqah (unrestricted Mudarabah). However Mudarib cannot, without the consent of Rab-ul-Maal, lend money to anyone. Mudarib is authorized to do anything, which is normally done in the course of business. However if they want to have an extraordinary work, which is beyond the normal routine of the traders, he cannot do so without express permission from Rab-ul-Maal. He is also not authorized to: keep another Mudarib or a partner mix his own investment in that particular Mudarabah without the consent of Rab-ul Maal.

Conditions of Offer & Acceptance are applicable to both. A Rab-ul-Maal can contract Mudarabah with more than one person through a single transaction. It means that he can offer his money to 'A' and 'B' both so that each one of them can act for him as Mudarib and the capital of the Mudarabah shall be utilized by both of them jointly, and the share of the Mudarib.³⁰

Rules & Conditions of Mudarbha

1. Two or more persons, of their own free will, should enter into contract whereby one party provides a specified amount of capital to the other who employs this capital in business to make profit.
2. Share of each party in the profit should be clearly defined in definite ratio or percentage. However, the loss of business

should be the responsibility of the Rab ul Mall. Mudarib will not get the profit as well as amount from capital. Similarly the profit of Mudarib will be decided from profit only.³¹

3. Form of Capital: According to Imam Abu Hanifa (R) and Imam Abu Yousuf (R) that Capital should be in the form of Dhirim or Dinar means standard money.³²

As per Imam Muhammad (R) that Capital should in the form of in cash and standard money of the time. Even if capital would be except the standard money of the time, it is not lawful.

In conclusion, the capital should be in terms of gold or silver coins or standard money in circulation and not in commodities.

4. Determination of Capital: It should be determined that what amount is to be invested for Mudarbha so later on confusion may not be occur.³³
5. The Rab ul Mal should hand over the capital to the Mudarib before the Mudarib starts business because in Mudarbha only Mudarib works on capital.³⁴

It is ambiguous if the contract is conditional that Rab ul Mal is responsible to work on capital or may consume the capital then the purpose of Mudarbha may not be achieved.³⁵

Power & Authorities in Mudarbha

For Mudarib:

1. The Mudarib is absolutely free to trade or do business with the capital as he deems fit. Any condition limiting his freedom may render the contract invalid.
2. Ameen (Trustee): To look after the investment responsibly, except in case of natural calamities.
3. Wakeel (Agent): To purchase from the funds provided by Rab-ul-Maal.
4. Shareek (Partner): Sharing in any profit.
5. Zamin (Liable): To provide for the loss suffered by the Mudarabah due to any act on his part.
6. Ajeer (Employee): When the Mudarabah gets Fasid due to any reason, the Mudarib is entitled to only the salary, Ujrat-e-Misl. In case there is a loss, the Mudarib will not even get the Ujrat-e-Misl.³⁶

For Rab ul Mall:

Followings powers are with Rab ul Mall:

1. To set the period of contract of Mudarbha.
2. Rab ul Mal may fix the business at particular place or city.

3. Even Rab ul Mal may fix the business of particular article.
4. While Rab ul Mal may not fix the contract with that condition which is unsafe for the business.³⁷

Mudarabah-Expenses

The Mudarib shares profit of the Mudarabah as per agreed rate with the investor but his expenses like meals, clothing, conveyance and medical are not borne by Mudarabah. However, if he is traveling on business and is overstaying the night, then the above expenses shall be covered from capital. If Mudarib goes for a journey which constitutes Safar-e-Sharai (more than 48 miles) but does not overstay the night, his expenses will not be borne by Mudarabah.

All expenses which are incidental to the Mudarabah's function like wages of employees/workers or Commission in buying/selling or stitching, dyeing expenses etc have to be paid by the Mudarabah. However all expenses will be included in the cost of commodities which Mudarib is selling for eg. if he is selling ready made garments then the stitching, dyeing, washing expenses etc. can be included by the Mudarib in the total cost of the garments.

If the Mudarib manages the Mudarabah within his city, he will not be allowed any expenses, only his profit share. Similarly, if he keeps an employee, this employee will not be allowed any expenses, just his salary.

If the Mudarabah agreement becomes Fasid due to any reason, the Mudarib's status will be like an employee, meaning:

Whether he is travelling or doing business in his city, will not be entitled to any expense such as meals, conveyance, clothing, medicine etc.

He will not be sharing any profit and will just get Ujrat-e-Misl (ordinary pay) for his job.³⁸

Distribution of Profit & Loss

It is necessary for the validity of Mudarabah that the parties agree, right at the beginning, on a definite proportion of the actual profit to which each one of them is entitled. The Shariah has prescribed no particular proportion; rather it has been left to their mutual consent. They can share the profit in equal proportions and they can also allocate different proportions for Rab-ul-Maal and Mudarib. However in extreme case where the parties have not predetermined the ratio of profit, the profit will be calculated at 50:50.

The Mudarib & Rab-ul-Maal cannot allocate a lump sum amount of profit for any party nor can they determine the share of any party at a specific rate tied up with the capital. For example, if the capital is Rs.100,000/-, they cannot agree on a condition that Rs.10,000 out of the profit shall be the share of the Mudarib nor can they say that 20% of the capital shall be given to Rab-ul-Maal. However they can agree that 40% of the actual profit shall go to the Mudarib and 60% to the Rab-ul-Maal or vice versa.

It is also allowed that different proportions are agreed in different situations. For example, the Rab-ul-Maal can say to Mudarib "If you trade in wheat, you will get 50% of the profit and if you trade in flour, you will have 33% of the profit". Similarly, he can say "If you do the business in your town, you will be entitled to 30% of the profit and if you do it in another town, your share will be 50% of the profit".

Apart from the agreed proportion of the profit, as determined in the above manner, the Mudarib cannot claim any periodical salary or a fee or remuneration for the work done by him for the Mudarabah.

All schools of Islamic Fiqh are unanimous on this point. However, Imam Ahmad has allowed for the Mudarib to draw his daily expenses of food only from the Mudarabah Account. The Hanafi jurists restrict this right of the Mudarib only to a situation when he is on a business trip outside his own city. In this case he can claim his personal expenses, accommodation, food, etc. but he is not entitled to get anything as daily allowances when he is in his own city.

If the business has incurred loss in some transactions and has gained profit in some others, the profit shall be used to offset the loss at the first instance, then the remainder, if any, shall be distributed between the parties according to the agreed ratio.

The Mudarabah becomes void (Fasid) if the profit is fixed in any way. In this case, the entire amount (Profit + Capital) will be the Rab-ul-Maal's. The Mudarib will just be an employee earning Ujrat-e-Misl.

The remaining amount will be called (Profit).

This profit will be shared in the agreed (pre-agreed) ratio.³⁹

Termination of Mudarabah

The duration of Mudarabah is neither predetermined nor limited but either party can terminate it by giving a notice of his intention to do so.

The Mudarabah will stand terminated when the period specified in the contract expires. It can also be terminated any time by either of the two parties by giving notice. In case Rab-ul-Maal has terminated services of Mudarib, he will continue to act as Mudarib until he is informed of the same and all his acts will form part of Mudarabah.

If all assets of the Mudarabah are in cash form at the time of termination, and some profit has been earned on the principal amount, it shall be distributed between the parties according to the agreed ratio. However, if the assets of Mudarabah are not in cash form, it will be sold and liquidated so that the actual profit may be determined. All loans and payables of Mudarabah will be recovered. The provisional profit earned by Mudarib and Rab-ul-Maal will also be taken into account and when total capital is drawn, the principal amount invested by Rab-ul-Maal will be given to him, balance will be called profit which will be distributed between Mudarib and Rab-ul-Maal at the agreed ratio. If no balance is left, Mudarib will not get anything. If the principal amount is not recovered fully, then the profit shared by Mudarib and Rab-ul-Maal during the term of Mudarabah will be withdrawn to pay the principal amount to Rab-ul-Maal. The balance will be profit, which will be distributed between Mudarib and Rab-ul-Maal. In this case too if no balance is left, Mudarib will not get anything.⁴⁰

Difference between Musharakah and Mudarabah

“*Mudarabah*” is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called “*rabb-ul-mal*”, while the management and work is an exclusive responsibility of the other, who is called “*mudarib*”.

The difference between musharakah and mudarabah can be summarized in the following points:

1. In Musharkah all partners invest but in Mudarabha only Rab-ul-Maal invests.
2. In Musharkah all partners participate in the management of the business and can work for it. But in Mudarabha Rab-ul-maal has no right to participate in the management which is carried out by the Mudarib only.
3. In Musharkah all partners share the loss to the extent of the ratio of their investment. But in Mudarabha only Rab-ul-maal suffers loss because the Mudarib does not invest anything. However this

is subject to a condition that the Mudarib has worked with due diligence.

4. In Musharkah the liability of the partners is normally unlimited. If the liabilities of business exceed its assets and the business goes in liquidation, all the exceeding liabilities shall be borne pro rata by all partners. But if the partners agree that no partner shall incur any debt during the course of business, then the exceeding liabilities shall be borne by that partner alone who has incurred a debt on the business in violation of the aforesaid condition. But in Mudarabha the liability of Rab-ul-maal is limited to his investment unless he has permitted the Mudarib to incur debts on his behalf.

As soon as the partners mix up their capital in a joint pool, all the assets become jointly owned by all of them according to the proportion of their respective investment. All partners benefit from the appreciation in the value of the assets even if profit has not accrued through sales. The goods purchased by the Mudarib are solely owned by Rab-ul-maal and the Mudarib can earn his share in the profit only in case he sells the goods profitably.

Mudarbha Financing in the recent banking

The Islamic bank's clients enter into mudarbaha contract with the bank where some time bank plays a role as Mudarib and sometime Rab ul Mal (due to a joint pool of bank). The amount of capital is credited to the mudarbaha account which the bank opens for the purpose of managing the mudarbaha. The mudarib manages the mudarbaha and oversees the purchase, storage, marketing and sale of the goods. He is personally responsible for any losses or expenses resulting from any mistakes in the specifications since the bank does not bear any such losses. In short, the mudarib complies with the detailed terms of the contract in relation to the management of the venture / project, such term being generally dictated by the bank. The contract would automatically be cancelled by its expiry date or in other situations. The mudarib must return the funds of the mudarbaha to the investor/ bank with any compensation for keeping the funds during the time of the contract without making them productive. The Islamic bank takes many steps to ensure that its capital advance and expected return on this capital is given to the bank on time as specified in the contract. The Islamic bank agrees with its mudarbaha client on the profit-ratio which is specified in the contract. This ratio would be depend inter alia on the bargaining power of the client, the

profit forecast of the mudarbaha, the market interest-rate, the personal characteristics of the client and the marketability of the goods as well as the duration. If the mudarbaha does not result in any profit, the mudarib does not receive any remuneration for his labor/ work. In case of loss, the bank bears the loss as long if it is not proved that the mudarib misused or mismanaged the mudarbaha funds or acted contrary to any of the terms of the investor. If proved so, the mudarib bear the loss.

If *mudarib* wants to invest some of his money into the business of *mudarabah*.

In such cases *musharakah* and *mudarabah* are combined together. This type of partnership will be treated as a combination of *musharakah* and *mudarabah*.⁴¹

Analysis of the Muddarbaha Financing

Banking finance based on classical mudarbaha principle but practically varied from it. Here one thing is cleared the Islamic banking redesigned from the conventional banking and it was tried by contemporary Muslim economists and scholars. But if we see it at grass root level; Islamic economical system based on followings:

- Meaningful belief on Almighty Allah such as we pay Zakat with this belief that Allah Purifies and increases our wealth, Likewise in Mudarabha, according to Islamic teaching we do belief that profit or loss is in the Hand of Allah. But the Islamic banking is empty from this spiritual belief just like other conventional banks and try to get only the profit.
- The Classical Mudarbaha based on honesty, truth and faithfulness while in the recent practice of Mudarbaha; role of mudarib is away from these characteristics.
- The Classical Mudarbaha was practiced to cooperate and help those people who did not have money/ capital.
- Guarantee is not taken in the Classical Mudarbha but in the recent Islamic banking, documents of properties, gold or other sort of articles are taken as guarantee. Although Islamic Law does not allow the investor to demand guarantees from mudarib.⁴²
- Ratio of profit is set according to the IBOR (LIBOR/ KIBOR) which are interest based benchmark. Therefore the presence of Riba is sure.
- The nature of classical mudarabha is bilateral but this nature can't satisfy the Islamic banking system and in the recent practice

mudarabha become multilateral (collective Mudarabha) the bank has to deal a large number of depositors and mix their funds together. In this way, it would be become very difficult to decide the liability of loss and the distribution of profit to different investors and entrepreneur.

- In the recent banking, banks are taking fee charges either they are Mudarib or Rab ul Mal. In classical Mudarbha this ort fee charges was not receive in both roles.
- According to the banking system the ratio of liquidity is very low therefore practice of mudarabha in Islamic banks is less while it is a main pillar of Islamic economics.

Conclusion

The economical system of Islam is proclaimed the belief on Allah, honesty, truthfulness, cooperation and transparency etc. That's why Islam introduced the economical instruments zakat, sadqat, qard-e-hasana, mudarabaha, sharakt etc. The sense of classical mudarabah and current mpractice of mudarabha should same.

We welcome to our destruction if we take others money or share by unfair means as Allah stated that:

“O You who believe! Squander not your wealth among yourselves in vanity, except it is for some business (trade) by mutual consent, and kill (destroy) not yourselves. No doubt Allah is ever Merciful too you.”⁴³

As mudarbah is being used as an alternate of Riba so the system of Islamic banking should avoid using the interest based benchmark. And this could be possible if the interest based banking is entirely ended from the country.

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- ²³ Al-Sarkasi, Vol:22, Pg-18.
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