Challenges and Solutions for *Mudarabah* as the Prime Investment Tool of Islamic Financing: A Literature Review

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ABSTRACT

Mudarabah is an equity-based, completely *Riba-free* investment tools for Islamic Banks and financial institutions. Being a risk-sharing financing system, it helps to establish justice in the financial sector as required by the Islamic *Shariah* objectives for a balanced economic and social development. But in practical situations there are no use of this tool for Islamic financing in the Islamic Banks and financial Institutions in Bangladesh. The study's main objective is to investigate the challenges for non-performance of *Mudarabah* financing system in Bangladeshi Islamic Financial Institutions and recommendation of possible solutions.

This is a comprehensive literature review of current and related articles of the scholars around the world to find out the possible recommendations. A qualitative methodology is adopted to achieve the objectives of this study by using secondary data. This study explores the reality of less preference for the *Mudarabah* financing by Islamic Banks and Financial Institutions. The challenges are the moral hazard, agency problem, absence of regulations, issue of Shariah board, financial inclusion. This study recommended for a regulation of Islamic banking, Knowledge development professionals, Central shariah board and Independent Shariah audit and disclosures of shariah audit findings and application of fintech. The recommend solutions and its implementation may enhance the effectiveness and credibility of *Mudarabah* financing for a shariah compliance of Islamic financing system in Bangladesh.

Keywords: *Mudarabah*, IFIs, Shariah Compliance, *Riba.*

INTRODUCTION

Mudarabah investment of Islamic Finance being an equity-based financing system in the economy as a contrary to *Riba*-based and debt-based financing system for a balanced economic and social development by improvement of knowledge, expertise, innovation, motivation of new business, risk sharing from one to all, reduction of unemployment, moral and ethical development in the society. As there is a thumb rule of Islamic financing that no one may claim any profit without taking a risk which is popularly known as *Al-ghounm bi al-ghourm* and the Profit and Loss Sharing or *Mudarabah* model was developed from this rule (Bhatti & Bhatti, 2010); Jedidia, 2020*)*. This states that all participants must share the risks and rewards of a financial transaction. Allah (SWT) has permitted business and prohibited *Riba* (interest) (Al Quran 2:275) and the main characteristic of a business is the risk of losses. *Mudarabah* mode of transaction is regarded as the cornerstone of Islamic financial system since it advocates risk sharing and equitable distribution of risk which is considered as non-exploitative, socially productive as well as social welfare oriented (Alfarisi, 2015). The center point of difference between the Islamic Banking and Conventional Banking is *Mudarabah* (Murshid & Hussain, 2016).

The *Mudarabah* finance concepts were well known during the Prophet Mohammad (PBUH) (Sherif, 2020); (Issa, 2020a; Rahman & Riyadh, 2016; Wolf, Nabin, & Bhattacharya, 2012). The journey of *Mudarabah* continued up to the nineteenth century. Still, the control of the Western colonial powers divided the Islamic world into many small states. The capitalist system effectively replaced the existing financial scheme that complied with Islamic Sharia objectives (Jedidia, 2020). That is why the innovative idea of *Riba*-free

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banking against the conventional banking system was further introduced in the late 1940s by some of the Islamic scholars like Anwar Qureshi in 1946, Mahmud Ahmad in 1952, Naiem Siddiqi in 1948 and others and their proposal for the Islamic banking system was based on the original concept of *Mudarabah* (Profit Sharing) (Rahman & Riyadh, 2016).

The Messenger of Allah (PBUH) said: "Till one of the two partners does not commit dishonesty, I am a third partner of them." He also said, "There is a blessing in *Mudarabah*" (Mughal, 2012). Four Caliphs of Islam continued the Islamic finance system established by Mohammad (PBUH). Then *Mudarabah* (profit sharing) was practiced by Caliph Utman (R.A.), Caliph Umar (R.A.), two of his sons, Abdullah Ibn Abbas (RA) (Åström, 2011). The ancient Arabs also used the term *Muqaradah*, and the Roman used the term *Commenda* to mean *MUDARABAH* (profit sharing) in an early appearance in Roman law of the early Middle Age. The *Commenda* was an agency contract, like equity-based investment or *Mudarabah (*profit sharing*)* contract, that originated in Italy and spread from west to east up to 16thcentury. It was a widespread business agreement between Muslims and non-Muslims worldwide (Ghayad & Hamdan, 2021).

Whereas traditional debt-based financing system is exploitative, predatory and bears the allegation of *Riba* (Bougatef, Nakhli, & Mnari, 2020; Fianto, 2020; Chowdhury, Shoyeb, Akbar, & Islam, 2016; Alshater, Saba, Supriani, & Rabbani, 2022). The *Mudarabah* mode of financing has undergone various evolutions to fulfill the needs of fast-developing Islamic finance. Currently, they become less preferable due to allegations like moral hazard compared to debt financing instruments such as *Murabaha* (Alshater, Saba, Supriani, & Rabbani, 2022), however, the allegations are not unsolvable. In *Murabahah* financing, banks receive a fixed return from its customer, which is based on usury and debt as the customer has to pay to the bank is fixed at the beginning of the contract *(*Sherif, 2020; Issa, 2020a; Rahman & Riyadh, 2016; Wolf et al., 2012; Ghayad, Hamdan, & Professor, 2021).

Although, Islamic Banks increased remarkably; their growth rate is 15% to 20%; Conventional banks are also doing Islamic Banking operations through their branches and windows as they can accommodate debt-based products of Islamic Banking system very easily. As the banks do not share loss of business of its customers, the investment portfolio of Islamic Banking is dominated by this debt-based products, similar to the conventional banks where the share of *MUDARABAH* investment is very few (Chowdhury et al., 2016; Habib & Hossain, 2020; Issa, 2020a) (See table 1).

Table 1: Summary of Islamic Banking Wing Research Department Bangladesh Bank

Mudarabah/Equity based investment	0.62%	1.06%
Debt-based Investment	99.38%	98.94%
Total	**100.00%**	**100.00%**

Source: Islamic Banking Wing Research Department Bangladesh Bank, 2022.

In Islamic Banking and finance system, IBs are much reluctant to prefer business that was done and by Rasulullah (*sallahu alyhi wa sallam*) himself and his *shahaba* (RA) due to the effect of western business system of capitalism. However, equity-based financing represents the pure Islamic banking structure and should be promoted as a priority for governing true Islamic Banking (Shaikh, Ismail, Mohd. Shafiai, Ismail, & Shahimi, 2017; Ali & Javaid, 2020).

Performance of *Mudarabah*

According to Islamic Banking Wing Research Department Bangladesh Bank, 2022 *Mudarabah* was only .62% where as debt-based products like *Murabaha*, *Ijara*, *By-salam*, etc. secured 99.38% in the total country's investment portfolio. As the Islamic banking system gains popularity, many people are doubting its viability since it does not adhere to the goals that led to its development. According to some academics, IFI is essentially providing conventional services under the *Mudarabah* brand rather than *Mudarabah* services itself (Mahdi & Rahaman, 2020). According to supporters, *Mudarabah*-based financing tools outperform other financial instruments. However, in reality, Islamic banks that provide debt-based financing disregard *Mudarabah* (Chowdhury et al., 2016; Farihana & Rahman, 2021). Due to fixed profit-based, risk is transferable, *Murabahah* dominates over the *Mudarabah* form of transactions in Islamic banking investments (Bougatef et al., 2020).

Reasons behind the low implementation of the *Mudarabah* mode of transactions by Islamic banks are debatable in which one of the factors that is blamed for its low implementation is the moral hazard factor. (Mansour, Ben Abdelhamid, & Heshmati, 2015) utilized a specific set of assumptions to construct a model of Islamic banking in order to demonstrate the rationality of the extensive use of debt-like instruments by IFI. Moreover, there have been many works that tried to reduce asymmetric information in *Mudarabah* contracts. For example, the agent's financial participation in the project's capital (Karim, 2020) may reduce moral hazard. This work is consistent with the work of Nabi (2013) who suggests agents to put in a minimum capital as well as be awarded a minimum profit share. This is also in line with other research (Elfakir & Tkiouat, 2015) which rationally claims that under the *Mudarabah* contract, moral hazard is reduced as both agents face the same destiny of losing their capital. The conclusion is derived under the assumption that all the bargaining power is with the banks and the banks set the entrepreneur's equity share equal to the entrepreneur's level of moral hazard (Promwichit, Mohamad, & Hassan, 2013). However, the problem that exists until today is that there is no thorough analysis done in determining the feasibility of their assumption and their working. A thorough research is needed in analysing the validity of their findings (Mansour et al., 2015)."

In the recent literature (Rahman & Gholami, 2020; Jedidia, 2020; Intansari, 2020; Bougatef et al., 2020; Fianto, 2020), *Mudarabah* are the only modes that are claimed to reflect the true spirit of Islamic finance which focuses more on the social responsibility of financial intermediaries towards the promotion of entrepreneurship and the financial inclusion of the poor and unbanked segment of the society. However, the current practice of IFIs has failed to integrate *Mudarabah* modes and it is mostly based on debt-like finance which led to major criticisms for the overuse of what are thought to be controversial contracts such as *Murabaha* (cost plus sale) and the absence of risk-sharing component. Many economists have examined the current practice of IFIs, reasons behind the unpopularity of *Mudarabah* instruments, and how their application remain challenging at a practical level.

The basic structure of Islamic Banking is constructed upon two main pillars; the abolition of *Riba* from all of its transactions and another is the use of *Mudarabah* (Profit sharing) mechanism in its deposit collection and investment being prime *Shariah*-compliant tool of Islamic finance (Sapar, 2017). Presently in practice, IBs put their utmost effort into maintaining the first pillar strong technically but the second pillar is abandoned to its fate (Mansour et al., 2015; Maski, Kafabih, & Hoetoro, 2018; V. Promwichit et al., 2013). A significant gap has been created between the practice and the theories of Islamic Banking activity (Mirakhor & Zaidi, 2007; Mohamed, 2016; Özkan, 2014)

Researchers also identified some problems of implementation of equity-based tools by IBs, such as the requirement of legislation, absence of awareness, development of knowledge, changes in the mindset of IBs, higher risk, lack of collateral security, moral hazard problems, dominating of *Murabaha* product, absence of full-fledged legal framework, inherently vulnerable to agency problems, competition with conventional banks, Shariah Supervisory Board (SSB) issues, etc. They have also provided their recommendations that are still ineffective due to some paucity, and ambiguity remains in their practical application (Mahdi & Rahaman, 2020; Manan & Abdullah, 2012; Mirakhor & Zaidi, 2007; Murshid & Hussain, 2016; Ricketts,

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2009; Shaikh et al., 2017).

Researchers recommended, Scholars' initiatives to ensure higher utilization of equity-based tools of IBs following the *Mudarabah* mechanism, its new products, and models to be undertaken under the Central Shariah Board (Ajmi, Aziz, & Kassim, 2020; Ben Jedidia, 2020). By practicing the *MUDARABAH* investment, IB could create thousands of entrepreneurs. But as it is well-known, the investment of Islamic banks is dominated by *Murabaha* which is not the most useful tool of investment for enhancing entrepreneurship (Assagaf, 2020; Bank, 2020). Although this product is permitted in Islam it may be defined as the Shariah-compliant financing but not purely Shariah-based financing of IB (Afkar, Utomo, Miradji, & Hariawan, 2020; Warninda, Ekaputra, & Rokhim, 2019).

Islamic Banking are in operations in Bangladesh

The latest information of Islamic Banking are in operations in Bangladesh have been collected from the publication of Bangladesh Bank Quarterly Report on Islamic Banking in Bangladesh (April-June 2023) which are presented below:

Table 2: Number of Islamic Banks, Branches and Windows

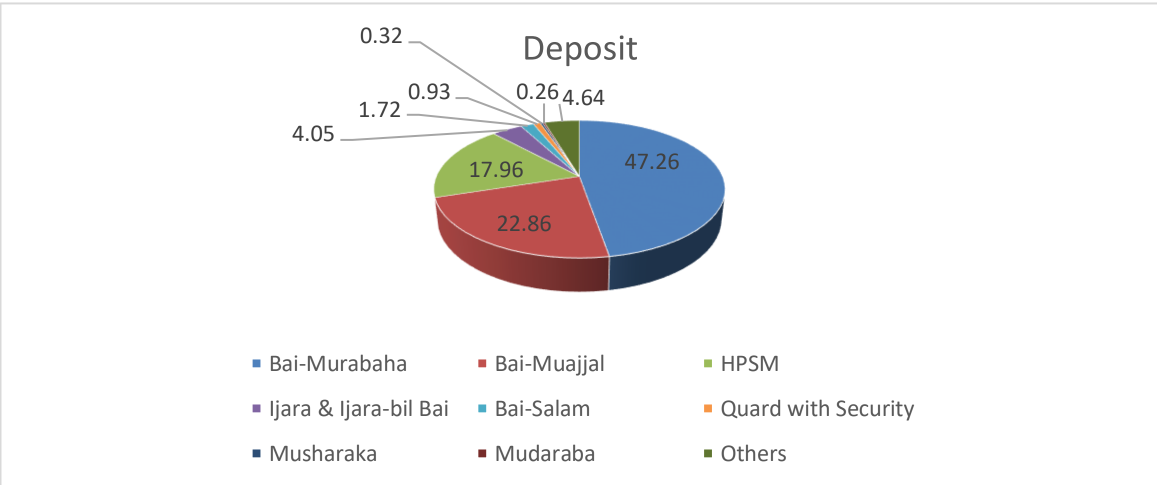
	Full-fledged Islamic Banks	No. of Branches	Conventional Banks having Islamic Branches	No. of Branches	Conventional Banks having Islamic Windows	No. of Windows
1	Islami Bank Bangladesh Limited	**394**	The City Bank Limited	**1**	Sonali Bank PLC	**58**
2	ICB Islamic Bank Limited	**33**	AB Bank Limited	**1**	Janata Bank Limited	**60**
3	Social Islami Bank Limited	**179**	Dhaka Bank Limited	**2**	Agrani Bank Limited	**17**
4	Al-Arafah Islami Bank Limited	**212**	Premier Bank Limited	**2**	**Pubali Bank Ltd**	**30**
5	EXIM Bank Limited	**148**	Prime Bank Limited	**5**	**Trust Bank Ltd**	**5**
6	Shahjalal Islami Bank Limited	**140**	Southeast Bank Limited	**5**	**Bank Asia Ltd**	**1**
7	First Security Islami Bank Limited	**209**	Jamuna Bank Limited	**2**	**Standard Chartered**	**46**
8	Union Bank Limited	**112**	Bank Alfalah Limited	**1**	**Mercantile Bank Ltd**	**1**
9	Standard Bank Limited	**145**	NRB Bank Limited	**1**	**Midland Bank Ltd**	**296**
10	Global Islami Bank PLC	**99**	One Bank Limited	**2**	**NRBC Bank Ltd**	**14**
11			United Commercial Bank PLC	**1**	**One Bank Ltd**	**10**

12					Meghna BankLimited	**15**
13					Mutual Trust Bank Limited	**25**
14					Premier Bank Limited	**10**
15					United Commercial Bank PLC	**10**
Total		**1671**		**23**		**588**

Source: Bangladesh Bank Quarterly Report on Islamic Banking in Bangladesh (April-June 2023)

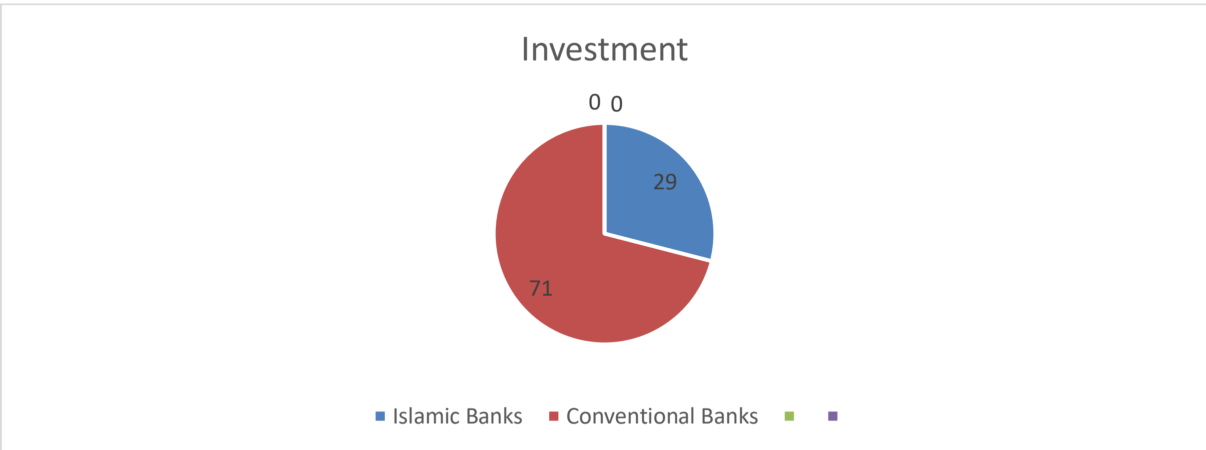
Total employment in the Islamic banking sector stood at 50,019 at the end of June 2023. It was 50,143 at the end of March 2023 and 48,728 at the end of June 2022 respectively.

Figure 1: Product-wise total Deposit of Islamic Banking in Bangladesh



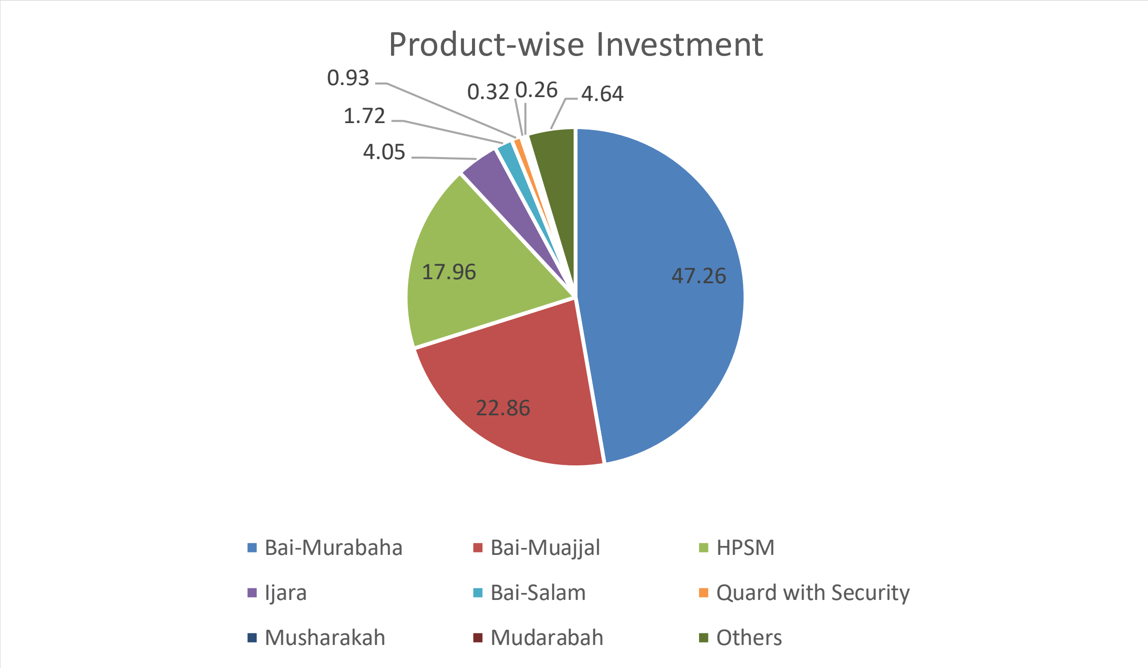
Source: Bangladesh Bank Quarterly Report on Islamic Banking in Bangladesh (April-June 2023)

Figure 2: Share of Investment of Islamic and Conventional Banking in Bangladesh



Source: Bangladesh Bank Quarterly Report on Islamic Banking in Bangladesh (April-June 2023)

Figure 3: Product-wise Investment of Islamic Banking in Bangladesh:



Source: Bangladesh Bank Quarterly Report on Islamic Banking in Bangladesh (April-June 2023)

It is opined that the needs for creating new Islamic financial instruments and modes, and developing the current ones can only be met by amelioration of employee's skills and knowledge through scientific research and training. So, Islamic banks should strongly focus on these issues. Efforts also need to be intensified professionally to further enhance its competitiveness to occupy larger share in the local as well as global financial markets (BB, 2023).

Identified Challenging Factors impacting Profit-Loss Sharing Implementation

This article addresses the challenging factors impacting performance of *Mudarabah* financing for providing with recommendations for industry stakeholders.

Competition

Islamic finance has been facing serious competition as conventional banking are playing both role of Islamic Banking as well as conventional Banking but the main objective of IB and CB are not the same, so IB may face difficulty due to market competition in coming decades (Jedidia, 2020).

Moral Hazard

It is opined that *Mudarabah* contracts are caused by the existence of asymmetric information, problems of adverse selection and moral hazard. Due to imperfect information that is inherent in *Mudarabah* (profit sharing) contracts, it has been declined as an important financing (Hiep & Binh, 2020). The research findings are, *Mudarabah* contracts are vulnerable to agency problems, riskier, not feasible for short-term funding, high monitoring costs, lack of transparency, asymmetric information (Ghayad et al., 2021). The researcher identified the moral hazard for asymmetric information problems and draw a solution also but also mentioned that the popular product of IB *Murabaha* is riskier than *Mudarabah* (Profit Sharing) in terms of moral hazard (Issa, 2020; Yazar Soyadı, Yazar Soyadı, & Fauzi, 2020). The researcher proved the better performance of Islamic Microfinance investment under *Mudarabah* in the case of the disadvantaged entrepreneurs (Herlangga, 2021; Suryani & Fathoni, 2020). As "a faithful Muslim, the entrepreneur needs to work in a trustworthy manner and carry out his responsibility truthfully with the intention of obtaining Allah's blessings and not for his self-interest (Ryandono, Kusuma, & Prasetyo, 2021; Yazar Soyadı et al., 2020)."

Shariah Supervisory Board

Shariah Supervisory Board (SSB) is not independent in their Shariah decision making process and activities. It is directly or indirectly influenced by the Board of directors and the management. The practices and functions of the SSB, their decision-making and other activities are influenced by the Board of directors indirectly (Alam et al., 2021). It has been argued by the Islamic scholar that IBs should return to their fundamental functions of providing innovative Shariah-based investment products and services that add value to the economy and address the true deserving current and potential customers (Dchieche & Aboulaich, 2016; Othman, Majid, & Rahman, 2017). A "very vital issue of IB to evaluate the Shariah-compliance status of the Islamic banks in Bangladesh raised that all the Islamic banks under study are, more or less, violating Islamic Shariah (Alam et al., 2021). Market discipline for Islamic banks is analyzed and suggested that policy makers should consider strengthening supervisory powers and continue close monitoring for the improvement of the safety of IBs due to not having strong market discipline (Sawafta, 2021).

Murabaha

Islamic banks preferred utilizing *Murabaha* because IBs are concerned about their commitments for paying back depositors' money. As *Mudarabah* is a long-term investment tool as well as a risky instrument, there were seriously worries about a mismatch of funds of IB. *Murabaha*, by contrast, gives fixed returns which could be repaid to depositors without problems (Herlangga, 2021; Sawafta, 2021; Yustiardhi et al., 2020). So, IB banks technically avoid the equity-based products of investments. But it is argued that *Mudarabah* (profit sharing) and *Musharakah* (profit loss sharing) principles are the basic equity financing instruments for Islamic business contracts (Issa, 2020b; Miasary, 2020; Suryani & Fathoni, 2020). The Central banks can control economic activity for efficient allocation of resources by using *Mudarabah* products of Islamic finance (Alam et al., 2021; Mahdi & S. Rahaman, 2020; Sawafta, 2021).

Islamic finance solutions have matured enough and they will face various challenges in the coming decades, due to conventional banks offering, increasingly, Islamic products through Islamic branches and windows (Mustafa, 2020). The urgent need of a comprehensive environment and regulatory framework is emphasized, so that IB and finance development can be ensured. Activities of IBs are still under the question of stakeholders due to similar nature investment transactions like conventional Banks (Intansari, 2020). The "excessive use" of *Murabaha* has often led to doubtful practices, reflecting it closer to interest-bearing debt (Alshater, Saba, Supriani, & Rabbani, 2022)

In practice, Islamic finance often involves structuring Shariah-compliant products that appear like conventional products. According to Julia and Kassim (2020) and (HS, 2020), Islamic banks are not different from conventional banks in Malaysia. The above analysis of the challenges of IB requires urgently the implementation of the *Mudarabah* under the Islamic financial system. Despite some valuable recommendations in their research remains ineffective. So, it needs more study to solve the issues of *Mudarabah* investment development under Islamic Financial Institutions.

The "researchers opined that the *Mudarabah* contracts are to be revived but the existing Islamic Banking may not be a fertile soil for *Mudarabah* to bloom unless the business relationship context between investors and entrepreneurs is developed with believed each other to recognize its real benefits. It is also noted that the *Mudarabah* concepts are not known to many including the entrepreneurs who are looking for capital and investors who wish to grow their savings. This knowledge deficiencies have resulted in lower trust in the true potential of the *Mudarabah* (Ghayad et al., 2021)."

The researchers expressed concern over the mushrooming of Islamic banking operation in parallel with the conventional banking activities (Nor & Ismail, 2020; Suryani & Fathoni, 2020). Due to dual banking operation, IBs hold huge responsibility in order to maintain credibility by ensuring that all its products offered, operations, processes are in accordance with *Shariah* compliance issues. To protect the interests of the stakeholders risk management strategies are required and future research is recommended to establish *Mudarabah* investment (Mustafa, 2020). Risk refers to put oneself or someone or something in danger, failure, or loss while Islamic risk management refers to *mukhatarah* (risk) as the situation that involves the probability of deviation from the path or compliance requirement that leads to the expected or usual result and the likelihood of loss.

Critics "have argued that IBs in a real sense are practicing "artificial *Murabaha*" by providing interest-based loans to their customers. They further claim that Islamic banks are charging pre-determined mark up (usually equivalent to the ongoing interest rate) under different names and pretexts to justify such questionable practices (Intansari, 2020). It is practically tending to conceal interest under different pretexts (Julia & Kassim, 2020). It is recommended to designed *Mudarabah* rules to fulfill the risk-sharing finance necessary for the promotion of entrepreneurship and the creation of SMEs (Imronudin & Hussain, 2016). Theoretically, Islamic banks' business model differs from conventional banks and it is free from *Riba*, *Gharar* and *Maisir*. But in practice, Islamic finance often involves structuring Shariah-compliant products that appear similar to conventional products. IB mostly handles the debt-based products of investment. In this context, According to HS, (2020), Islamic banks are not different from conventional banks.

Research argued that the lack of adequate market discipline in the financial system is one of the major causes of the Global Financial Crisis. It influences Banks' excessive lending as well as high leverage leads ultimately the crisis. Risk-sharing of the Islamic Finance system of Islamic Banking can help inject much better discipline into the financial system substantially reduce financial instability (Mahdi & Rahaman, 2020). The debt-based financing discourages the potential entrepreneurs to start a business or a new venture in a society of disadvantaged with a heavy burden of interest added to the principal or initial borrowing which has to be repaid regardless of the outcome of the business venture. Alternatively, Islamic Venture capital can a fully *Shariah* complied investment equity product, it may offer higher returns and attributes which can be desirable for the Islamic finance industry but are practically less used products of Islamic Banking because of lack of awareness among the investors (Julia & Kassim, 2020).

Knowledge

Another "challenge of IB is the lack of educational systems in the Muslim majority countries to acquire theoretical and practical knowledge of Islamic economics and on the comparative economic system amongst Muslims for creating the knowledge-based awareness of the importance of Islamic Banking and Finance and availability of Islamic financial products and its features as alternatives to the product and services of conventional banking (Zainuldin & Lui, 2020). To overcome the situation, it needs of establishing diversified but parallel institutions as well as research centers in all the Muslim countries to ensure an adequate supply of skilled, knowledgeable and keen Muslim professionals, researchers, and specialists in the different disciplines of Islamic finance. Academic institutions need to expand the boundaries of their educational curriculum for providing proper knowledge of Islamic finance and to spread the education of Islamic economics and related laws, rules and regulations to meet the future challenges of the Islamic banking industry in all Muslim world (Sherif, 2020).

A capitalist economy is basically based on interest. Due to the effect of capitalism, Muslims elsewhere in the world has to accept and pay interest in different ways and transactions (Omer Mustafa, 2020) mostly because of a lack of knowledge of Islam. But Islam is the only way of life as directed by Allah (SWT). As per Islamic *Shariah*, Islamic virtues or principles should be the only way of life regarding all aspects of a person and not just only daily rituals such as Salat, Siam, Hajj, Zakat, etc. Society was and even tills to date much secular in nature (Alam et al., 2021)

Collateral

Just "like CBs, IBs extended their financial facilities to the established businesses concerns and individuals. It creates the rich to be richer and the poor remains as poor and the gap become wider between the rich and the poor. For a young entrepreneur, It is virtually impossible to meet up the requirements of a bank's security demands to secure financial support to start a new business or to develop or modernize an existing one (Issa, 2020b; Julia & Kassim, 2020; Mohd Nor & Ismail, 2020).

Government Regulation

Researchers have tried to find out the growth prospects of the Islamic banking industry in Bangladesh. They identify the challenges of IBs and concluded Islamic Financial System particularly the *Mudarabah* investment can bring out the most efficient banking and financial system if it gets support from the private and public bodies in terms of governance and direction (Ali, Javaid, & No, 2020; Mahdi & Rahaman, 2020; Uddin, 2021). Though both growth and popularity of Islamic banking in Bangladesh is remarkable, two very important modes of Islamic investment i.e., *Mudarabah* and *Musharakah* are yet to be practised. To give the Islamic banks a complete shape, there is no other alternative but to implement, practise and popularize the *Mudarabah* and *Musharakah* modes (Hossain, 2016; Sarker, 2005; Shaown, 2017).

The Shariah governance compliances and practices of global IFIs are not the same and these may differ due to many influential factors like diverse countries' legal rules and regulations required to monitor the overall functions of Islamic banks. Researchers argued that that IBs neither complies with the complete Shariah principles in all aspects nor violate fully in their overall functions because of less accountability in Shariah compliance, capitalism and interest-based economy, competition with conventional banking as well as some other inherent conflicting issues. It contradicts the concept of the maqasid al-Shariah of Islamic corporate governance. Islamic banks announce that they have been following Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) guidelines, but in practice, they do not follow the instructions accurately because all of the standards and policies of AAOIFI and the Islamic Financial Services Board are not applicable in many countries of the world due to its cultural, legal and regulatory structures.

Financial Inclusion

Financial Inclusion word is made with the combination of three words; finance, financial services, and technology (Ali et al., 2020; Mahdi & Rahaman, 2020; Uddin, 2021). Mahdi and Rahaman, (2020) defines Financial Inclusion as… "Technologically enabled financial innovations that could result in new business models, applications, processes, or products with an associated material effect on financial markets and institutions and the provision of financial services." The impact of Financial Inclusion on the banking and financial services industry is high (Kakhkharov & Bianchi, 2022; Thakor, 2020). Newer technological innovations, recent technological infrastructure development, and technology implementation across the financial and banking industry changing the way it operates and resulting in changing expectations of the customers (Mainardes, Costa, & Nossa, 2022)

According to the Global Fintech Index (2021), Bangladesh ranked 78th among 83 countries. However, the country wants to become a Financial Inclusion hub in Asia. The Financial Inclusion industry in Bangladesh is mostly represented by mobile financial service (MFS) providers, payment system operators (PSO) and payment service providers (PSP) (Rahman, Ahmed, & Shakil, 2021). Bangladesh Bank has recently introduced a regulatory innovation office for fintech under its payment systems department and also licensing for digital banking services. Delivery of state of art quality services using technology in banking industry enhance customer satisfaction and result in customer retention (Rubaiyat, 2020). It helps the banks in maintaining their competitiveness.

Moreover, Financial Inclusion has completely transformed the banking industry in Bangladesh (Rahman et al., 2021). Therefore, increasing interest in Financial Inclusion services by the customer in Bangladesh, which resulted in positive and negative both ways. The positive impact is the collaboration between FinTech and the banking industry leading to increased efficiency and effectiveness of the banking industry (Rapti et al., 2022). The transaction cost reduction is due to the collaboration of different stakeholders across the industry results in customer benefits. It also results in boosting performance and attracting new customers, improving customer engagement approaches, and enhancing brand loyalty as posited (Boamah & Murshid, 2019). This factor boosts the competitiveness of the industry in general on a global scale. With the help of Financial Inclusion in *Mudarabah* based banking can increase product and service offerings in the digital world. The unique mobile banking services provided by Bangladesh Bank. Modern channels (e-banking, m-banking), Digital Banking operations are possible with the help of Financial Inclusion in the banking industry to provide quality and convenient services to include deserving rural and people for a balanced development (Boamah et al., 2021).

Digital Banking and Financial Inclusion

Many researchers have argued that 90% of poor people are excluded from the inclusion of IB financial services and they have also recommended to reduce financial exclusion or FinTech by Islamic financial institutions leverage on technology, use equity-based modes of finance, and focus attention on Islamic microfinance, SME finance for micro and macroeconomic growth (Afkar et al., 2020; Aysan & Disli, 2019; Bidabad, Mohammadi, & Sherafati, 2019; Imronudin & Hussain, 2016; Promwichit, Shamsher & Hassan, 2013).

Fintech Bangladesh perspective

The innovation of FinTech approach in Bangladesh is mainly based on Mobile Financial Services (MFS). MFS fosters branchless banking or mobile banking services offered to banked and unbanked population groups in urban and rural area at a very reasonable rate. Using MFS, consumers in remote locations can add money to their mobile accounts at nominal charges without visiting a physical branch. MFS are registering steady growth in the country, with bKash leading the way. Contactless transactions due to COVID-19 have accelerated e-wallet adoption. Bangladesh has 85 million MFS-registered accounts. Digitized payments of utility bills and wages of private-sector workers have increased amid the crisis. Popular MFS offerings include bKash (BRAC Bank), mCash (Islami Bank Bangladesh), UCash, and Islamic Wallet (Al-Arafah Islami Bank). Some banks have launched their FinTech platforms. Dhaka Bank Limited (DBL) has introduced diversified services and uninterrupted banking, and Bank Asia is planning to form a neobank targeting the youth. Islami Bank Bangladesh plans to launch real-time online investment banking (Internet).

Recent development of Digital Banking in Bangladesh

Bangladesh Bank, the central bank of Bangladesh has recently invited application for from the qualified sponsors for licensing Digital Banking in Bangladesh. A total of 52 domestic and foreign entities have applied to the central bank for the license to set up digital banks (TBS, 20 August 2023), (The Daily star, August 20, 2023). The proposed Digital bank will operate without any branches, sub-branches, or ATM booths. There will be no in-person transactions, according to the Digital Bank guidelines approved by the central bank on 14 June, 2023. This will help to goahead Bangladesh one step more towards the Digital worlds by application of the Fintech facilities for better financial inclusion.

Based on the literature review this article provides with the recommendations for better performance of most shariah compliance tools of Islamic financing for Islamic banks and financial institutions in Bangladesh.

Islamic Banking Law and its application

Therefore, further research and improvement in this rising industry of Islamic Finance and its governance are important. Bangladesh, being 90% Muslim majority country, is yet to make a full-fledged Islamic Banking law in the country. But the Islamic Banks in the country is to follow the conventional banking laws like Bank Companies Act 1991 and other related rules and the Islamic Banks are also controlled by the guidelines issued by the central bank. Absence of long-term funds and a full-fledged Islamic Banking Law issues are to be solved to develop equity-based investment of Islamic banking (Julia & Kassim, 2020).

Central Shariah Supervisory Board

It is found that Islamic banks have a lower practice of maqasid al-Shariah. Non-disclosure of Shariah violations and compliance amount show the limitations of the annual report and create questions about the Shariah-compliance procedures (Alam et al., 2021; Julia & Kassim, 2020; Mahdi & S. Rahaman, 2020; Shaown, 2017). It is argued that most of the cases SSB are not independent and also have no power, guidelines of central banks for appoint of members of the SSB are not followed and there are knowledge gap in SSB (Alam et al., 2021; Julia & Kassim, 2020; Mahdi & S. Rahaman, 2020; Shaown, 2017).

Knowledge and Skill development

Institutions for Islamic finance, research centers for an adequate supply of skilled, knowledgeable and keen Muslim professionals, researchers, and specialists in the different disciplines of Islamic finance. Academic institutions need to expand the boundaries of their educational curriculum for providing proper knowledge of Islamic finance and to spread the education of Islamic economics and related laws, rules and regulations to meet the future challenges of the Islamic banking industry in all Muslim world (Sherif, 2020).

Designing of collateral system for *Mudarabah*

Structured collateral system specially for willful negligence of *Mudarabah* can be introduced.

Selection and monitoring of the partner in *Mudarabah*

Mudarabah is a partnership agreement, and the risk of a partnership business is unlimited. So, the Selection process of partner is the most vital point to overcome the situations of moral hazard problem. Application of fintech and monitoring system can be effective for *Mudarabah* failure.

METHOD

The purpose of this systematic literature review was to delve into and understand the intricacies associated with *Mudarabah* financing in Islamic banking, focusing on its challenges and the recommendations for enhancing its compliance and transparency.

Search Strategy

A systematic search of electronic databases, including Google Scholar and ProQuest, was conducted to identify relevant literature on the topic of religiosity and the adoption of Islamic banking.

Selection Criteria

Studies included in the review were limited to peer-reviewed journal articles to ensure the reliability of the sources. Articles were eligible for inclusion if they specifically discussed the challenges associated with *Mudarabah* financing in Islamic banking and presented proposals for its improvement.

Search Terms

The search was guided by a range of keywords and phrases:

"Factors affecting *Mudarabah* performance"

"*Mudarabah* challenges"

"*Mudarabah* issues"

"Recommendation for solutions of Murabaha issues"

Study Selection

From the search, twenty articles were identified and chosen based on their relevance and contribution to the research topic.

Data Extraction and Synthesis

The data from the selected articles were extracted and synthesized to provide a comprehensive overview of the challenges and recommendations associated with *Mudarabah* financing in Islamic banking.

Table 3: Summary of Adapted Systematic Literature Review Process

Step	Description
1	Define the objective of the review
2	Conduct a systematic search using specified electronic databases
3	Set specific selection criteria for studies to be included
4	Apply relevant keywords and phrases to guide the search
5	Identify and select 22 studies based on relevance and contribution to the research topic
6	Extract, synthesize, and analyze data from the selected studies
7	Report on the findings, highlighting challenges and potential solutions related to the research topic

DISCUSSION

Islamic finance has grown rapidly over the years, offering unique financial solutions rooted in ethical principles and Shariah guidelines. At the forefront of these innovative solutions is *Mudarabah* – an instrument promoting profit-and-loss-sharing. While its ethical underpinnings are commendable, several challenges surround its practical implementation. Through a systematic review of the literature, this discussion will further delve into the role and potential of *Mudarabah* as a cornerstone in ethical Islamic banking and finance.

From the works of Afkar et al. (2020) and Ajmi, Aziz, and Kassim (2020), it is evident that profit-loss sharing instruments like *Mudarabah* can have wide-ranging effects on the economic canvas. MSMEs, whichform the backbone of many economies, can benefit substantially from such schemes. Furthermore, the intertwining of Islamic finance principles with contemporary venture capital frameworks hints at the flexibility and potential adaptability of *Mudarabah* in modern financial landscapes. Any financial instrument's efficacy is directly influenced by the governance mechanisms in place. Alam et al.'s (2021) study on Shariah governance in Bangladesh underscores this crucial facet, highlighting the need for stringent governance structures. Alfarisi (2015) adds another dimension to this, bringing attention to the comparative resilience of Islamic banks, rooted in their ethical foundation, during financial crises. These principles don't merely provide moral satisfaction but also promise economic stability.

Alam et al. (2021) underscore the importance of Shariah governance in Islamic banks, especially in Bangladesh. They suggest that for a mechanism like *Mudarabah* to function effectively, robust Shariah governance systems are crucial. This sentiment resonates with the findings of Alfarisi (2015), who discusses the impact of financial crises on Islamic Banks compared to conventional banks. In such turbulent times, the resilience and ethical principles of Islamic banking, such as *Mudarabah*, can potentially offer a more stable alternative. Recent findings by Alshater et al. (2022) on Fintech in Islamic finance literature reveal that integrating modern financial technologies with traditional Islamic finance methods can create a synergistic effect, paving the way for a more inclusive and ethical financial ecosystem.

Jedidia's (2020) investigation into the effects of profit-and-loss-sharing on Islamic bank liquidity in the GCC countries implies that standardized practices in Mudarabah can lead to more stable liquidity management in the region. Drawing from the insights of multiple articles, such as those by Assagaf (2020), Åström (2011), and Aysan and Disli (2019), it becomes evident that for *Mudarabah* and similar instruments to be effective, there needs to be a decrease in asymmetric information, an enhancement in the structure of Islamic banking, and a deeper understanding of credit risks associated with small business lending.

A noteworthy observation comes from Alshater et al. (2022) who spotlight the merger of Fintech with Islamic finance. This synergy implies a future where financial inclusivity is paired with technological advancement, creating a dynamic and robust financial ecosystem that holds promise for both investors and beneficiaries. The importance of standardization in *Mudarabah* practices is highlighted by Ben Jedidia (2020), suggesting that uniform practices can lead to better liquidity management, especially in regions like the GCC. Assagaf (2020), Åström (2011), and Aysan and Disli (2019) collectively stress the imperatives of reducing information asymmetry, restructuring Islamic banking, and comprehending the nuanced credit risks, especially with MSMEs.

In brief, *Mudarabah*, with its ethical and resilient characteristics, stands tall as a commendable financial instrument in Islamic banking. Nevertheless, its widespread and effective implementation necessitates robust governance, technological integration, international standardization, and enhanced banking structures. The current trajectory, as suggested by the extant literature, hints at a bright future for *Mudarabah* and Islamic banking at large, but achieving optimal outcomes requires coordinated global efforts, education, and regulation. As the world becomes increasingly interconnected, it's imperative to ensure that ethical financing options like *Mudarabah* not only survive but thrive, bringing their unique value proposition to the forefront of global finance.

CONCLUSION

Mudarabah presents both individuals and businesses with an ethical substitute to interest-based financing within the realm of Islamic banking. This article offers actionable advice for those pondering over the prospect of adopting *Mudarabah* as their financing choice. It is crucial to grasp Islamic finance's core tenets, adhere to Shariah standards, evaluate credible institutions, assess pricing and conditions, recognize potential risks, and consult experts to adeptly maneuver through *Mudarabah* dealings. This discussion alsotouches upon refining the Shariah adherence of *Murabaha* financing. By amplifying the cost-plus-profit mechanism, fostering client participation, endorsing ethical procurement strategies, and pushing for increased transparency and accountability, *Murabaha* financing can better reflect Shariah's principles.

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Enacting these initiatives can augment the genuineness and clarity of *Murabaha* deals, bolstering the trustworthiness of Islamic finance.

Yet, the global application of *Mudarabah* practices faces hurdles, impacting the expansion and steadiness of the Islamic financial sector. Issues like inconsistency in practices, scarcity of proficient professionals, insufficient regulatory structures, and concerns around ethical adherence require attention. Recommended measures like the creation of universal standards, intensified training sessions, fortified regulatory mechanisms, and the encouragement of ethical procurement and adherence can pave the way for Islamic banks to refine their *Mudarabah* procedures. These strategies can foster growth, fortify the principles, and synchronize the Islamic financial sector, making it more attuned to Islamic guidelines and the dynamic requirements of stakeholders.

Furthermore, one pressing concern for Islamic banks is the absence of adequate pricing benchmarks for their products, Murabah included. Yet, by championing the creation of uniform pricing benchmarks, catalyzing collaboration for data exchange within the industry, establishing clear regulatory mandates for openness and accountability, and boosting research initiatives, this challenge can be tackled head-on. Such interventions would escalate clarity, equity, and competitive positioning in Murabaha operations, solidifying the trust and reliability of the Islamic financial domain.

The emphasis on ethical sourcing, transparency, and stakeholder involvement inherent in *Mudarabah* and Murabaha could serve as a beacon for other financial systems, urging them to consider the broader societal implications of their activities. It’s clear that the tools exist within the Islamic financial ecosystem to not only cater to its core demographic but to serve as a model for financial institutions worldwide. Yet, challenges remain, and the path forward requires collaboration across institutions, countries, and cultures. Standardizing practices and regulations, while respecting individual cultural and economic nuances, is a significant task but is necessary for creating a globally recognized and respected Islamic finance platform.

Furthermore, the role of technology, especially in the era of digital transformation and fintech, cannot be understated. Embracing technological advancements can provide the Islamic finance sector with the tools to enhance accessibility, transparency, and efficiency. By integrating modern tools with age-old ethical principles, there is an opportunity to present a robust alternative to conventional financial systems.

FINDINGS

This study tries to explore the reality of less preference for the *Mudarabah* financing by Islamic Banks and Financial Institutions. As the main objective of this study is to investigate the challenges for non-performance of *Mudarabah* financing system in Bangladeshi Islamic Financial Institutions and recommendation of possible solutions. It is found out that the critical challenges are the moral hazard, agency problem, absence of regulations, issue of Shariah board, financial inclusion.

SIGNIFICANCE

These findings contribute to the existing literature on Mudarabah Issues in Islamic finance and have important implications for policymakers, academics, and the Islamic Banking industry.

RECOMMENDATION

This study recommends for a full-fledged Islamic shariah regulation for the Islamic banking in the country, Knowledge development for professionals, Central shariah board and Independent Shariah audit and disclosures of shariah audit findings and application of fintech. The recommend solutions and its implementation may enhance the effectiveness and credibility of *Mudarabah* financing for a shariah compliance of Islamic financing system in Bangladesh. This study also recommends for further research taking more challenging factors with respect to diversified geographic perspectives.

In conclusion, the Islamic financial sector, with its emphasis on ethical and shared-risk principles embodied in mechanisms like *Mudarabah*, stands at a pivotal moment. With the right strategies, collaborations, and innovations, it has the potential not only to grow within its traditional markets but to influence and inspire global financial paradigms. As societies increasingly value transparency, fairness, and ethics, the Islamic finance sector can lead the way, offering a sustainable and practical roadmap for the future of global finance as this research may testify.

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