NUST Business School

Financial Markets & Institutes

Term Paper

'Mudarabah as a Mode of Finance: Theory, Practice & Problems'

Submitted to

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Annexure

Figure 1

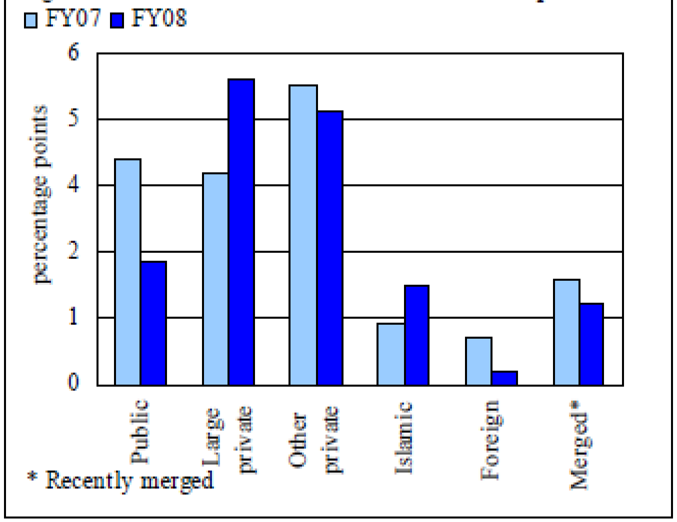


Figure 4.27: Banks' Contribution in Credit Expansion

Figure 2

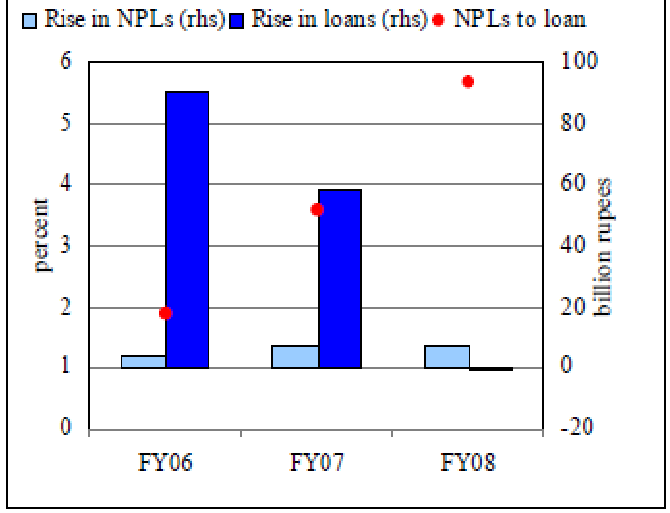


Figure 4.35: NPLs to Loan Ratio in Consumer Finance

(Source: SBP Annual Report 2007-08)

(Rs. In million)

Table 1: Consolidated Table of Sources and Uses of Funds: Islamic Banking Sector

Deposits	8,397	30,185	49,932	83,740	147,361
Borrowings	1,899	6,559	9,006	10,843	15,042
Capital & other funds	1,994	5,123	7,811	16,348	29,526
Other liabilities	625	2,276	4,745	8,363	14,017
TOTAL	**12,915**	**44,143**	**71,493**	**119,294**	**205,946**
Financing-Net	8,652	27,535	45,786	65,613	106,848
Investments	1,242	2,007	1,854	7,328	30,961
Cash, bank balance, placements	1,979	11,900	19,314	31,358	38,996
Other assets	1,042	2,701	4,539	14,996	29,141
TOTAL	***12,915***	***44,143***	***71,493***	***119,294***	***205,946***

(Source: Islamic Banking Sector Review 2003-2007, SBP Publications)

Figure 3

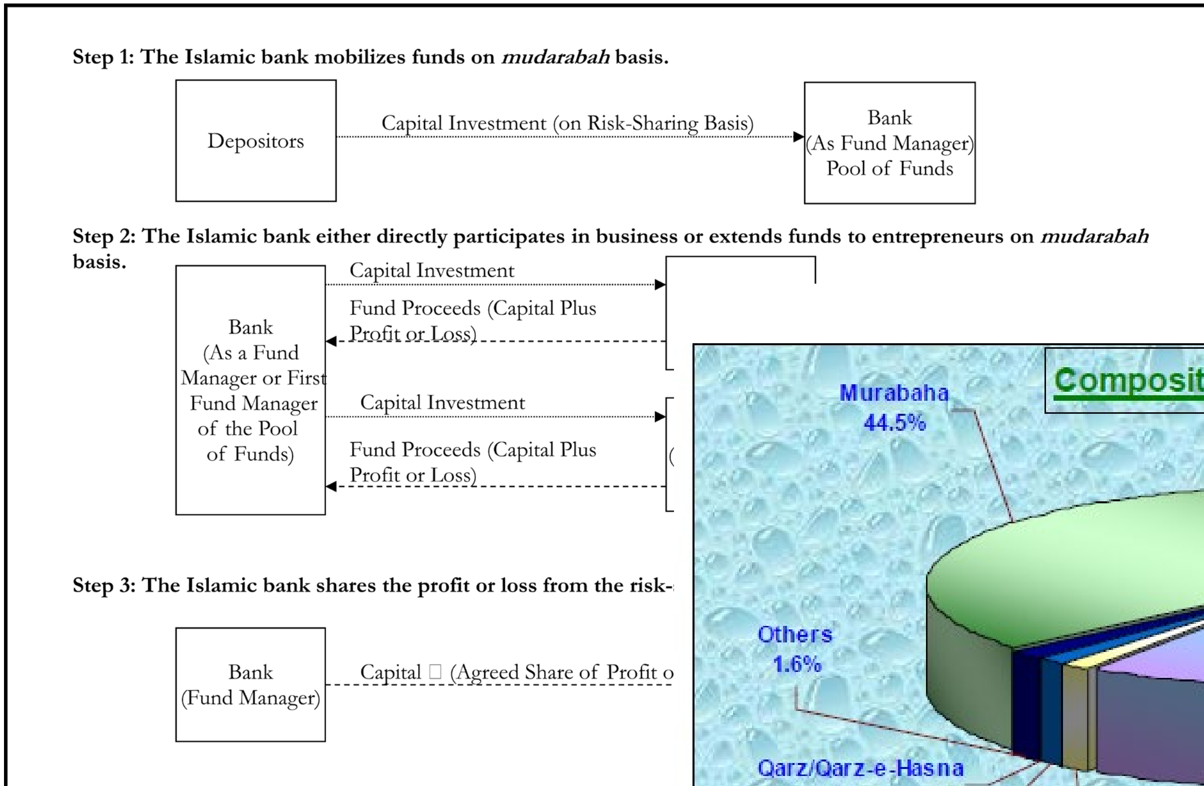
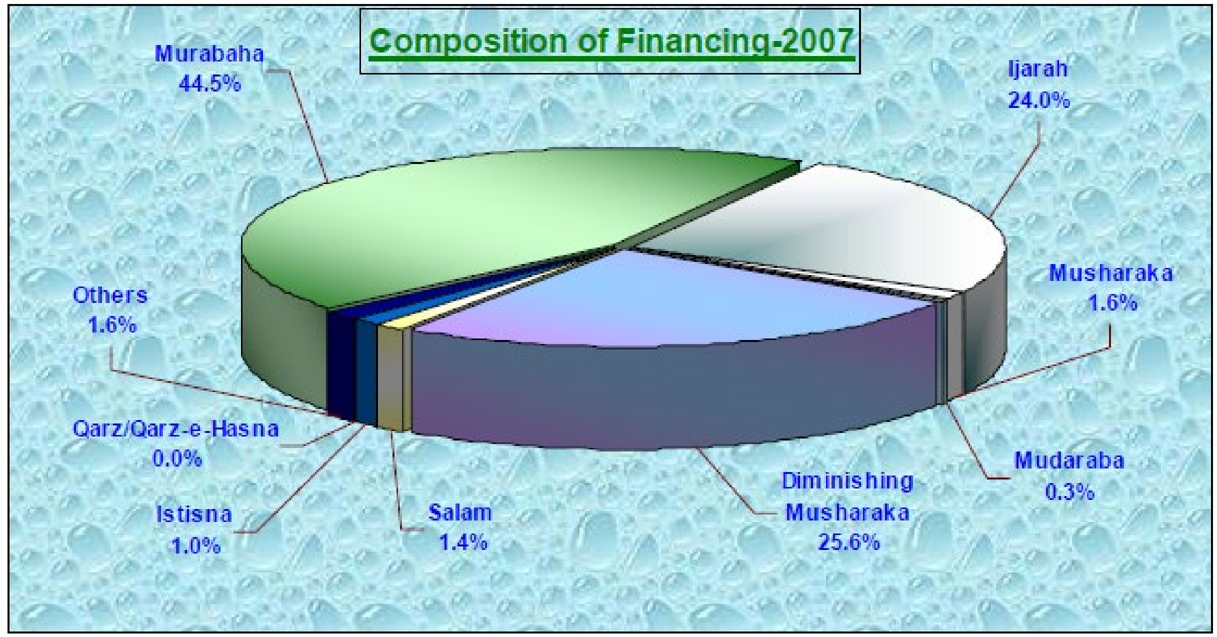


Figure 4



(Source: Strategy for Islamic Bankin

Table 3: Asset Vs Financing Growth in Islamic Banks

(Rs. in Million)

	2008	*2009*	*2010*	*2011*	*2012*
Expected Deposit Size	215,938	340,128	499,036	722,109	907,064
Annual Growth Rate	-	58%	47%	45%	26%
Expected Financing Size	184,641	277,153	413,594	600,014	731,591
Annual Growth Rate	-	50%	49%	45%	22%

(Source: Strategy for Islamic Banking, SBP Publications)

Table 2: Tentative Roll out Plan of IFSB Standards/ Guidelines

S. No.	Name of the Working Group	Status	Roll out Date
1.	Risk Management	Standard Issued	September 2007
2.	Capital Adequacy	Standard Issued	December 2008
3.	Corporate Governance	Standard Issued	June 2009
4.	Transparency and Market Discipline	Standard Issued	June 2009
5.	Supervisory Review Process	Standard Issued	June 2009
6.	Special Issues in Capital Adequacy	Under Process	Within Two years of issuance of final standard
7.	Market Conduct	Under Process	Within One year of issuance of final standard
8.	Shariah Governance	Under Process	Within One year of issuance of final standard
9.	Governance of Islamic Investment Funds	Under Process	To be implemented by SECP
10.	Corporate Governance of Takaful Operations	Under Process	To be implemented by SECP

(Source: Strategy for Islamic Bank

Table 4: Roll out Plan of Shariah Standards

S.No.	Shariah Standard	Roll out Date
a)	Murabaha to the Purchase Orderer	By December 2008
b)	Ijarah and Ijarah Muntahia Bittamleek	
c)	Investment Sukuk	
d)	Default in Payment by Debtor	
e)	Sharika (Musharaka) and Modern Corporations	
f)	Guarantees	By December 2009
g)	Mudaraba	
h)	Conversion of a Conventional Bank to an Islamic Bank	
i)	Salam and Parallel Salam	
j)	Qard (Loan)	By December 2010
k)	Istisna' and Parallel Istisna'	
l)	Dealing in Currencies	
m)	Debit Card, Charge Card and Credit Card	
n)	Settlement of Debts by set-off	By December 2011
o)	Transfer of debts	
p)	Jua'la	
q)	Financial Paper (Shares and Bonds)	

(Source: Strategy for Islamic Banking, SBP Publications)

Survey Question

Why Mudarabah mode of finance is un-popular compared to other Islamic modes of finance?

a) Alternative investments such as Lease and Mudarabah (mark up) are more profitable and less risky than Mudarabah.

b) There are not enough bankers who have enough knowledge in

1. Selecting profitable profit-sharing project
2. Managing profit-sharing project
3. Evaluating the profitability & risk of the project

c) Banks do not feel comfortable with the idea of sharing and managing a long term investment with another bank or person.

d) Monitoring and supervising cost of the Mudarabah is very high for the bank.

Classification	**Results**			
A		25%		
B	54%			
C			11%	
D				08%

Table 5: Survey Results

(Amount in Billion Rs.)

Modes of Financing	30-06-08		31-12-07		30-06-07	
	No. of Accounts	Amount	No. of Accounts	Amount	No. of Accounts	Amount
I. Interest Based	**414,816**	**221.0**	**307,429**	**203.9**	**293,057**	**185.2**
II. Islamic Modes	**4,511,251**	**2,594.6**	**4,612,405**	**2,409.3**	**4,874,915**	**2,190.9**
a) Mark-p in Price on Deferred Payment Basis	3,449,298	1,976.0	3,660,478	1,850.7	3,761,368	1,687.9
b) Rent-sharing	1,647	4.9	1,435	5.8	93,293	10.5
c) Qarz-e-hasna	241	0.4	6,474	0.4	4,787	0.4
d) Musharaka or Profit and Loss	2,184	12.3	1,497	5.5	1,592	3.8
e) Leasing	104,236	33.3	42,227	29.4	52,829	38.1
f) Hire Purchase	37,948	10.8	33,015	24.0	34,421	33.2
g) Buy Back	180,664	238.1	193,290	190.4	191,816	140.6
h) Development Charges	0	0	0	0	0	0
i) Mark Down in Prices	1,515	2.9	1,811	2.5	1,290	1.2
j) Service Charges	319,668	6.7	234,995	4.8	319,964	8.2
k) Concessional Service Charges	56	-	0	0	893	4.7
l) Other Islamic Modes	413,794	309.2	437,183	296.0	412,662	262.3
Total (I+II)	**4,926,067**	**2,815.6**	**4,919,834**	**2,613.2**	**5,167,972**	**2,376.2**

Table 6: Advances by Modes of Financing

(Source: SBP Annual Report

Table 7 Regression: Net Financing & Assets

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	67684.21	28659.86	2.361638	0.045841
Assets (Millions) (X1)	0.232024	0.022585	10.27331	6.94E-06

Table 8 Regression: Net Financing & GDP

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-523563	68352.79	-7.65971	5.96E-05
GDP(Annual %age change) (X2)	83209.59	7064.237	11.77899	2.47E-06

Table 9 Regression: Net Financing & Inflation

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-133386	331478.3	-0.4024	0.69793
Inflation (X3)	52242.8	44304.88	1.179166	0.27221

Table 10 Regression: Net Financing & Population

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-3818462	484607.7	-7.87949	4.87E-05

Population(X4)	25326.38	3014.739	8.400853	3.07E-05

Table 11 Regression: Net Financing & Current Account Balance

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-268055	187255	-1.4315	0.190172
Current account balance (X5)	120936.5	41721.29	2.898677	0.019932

Table 12 Regression: Net Financing & Per Capita Income

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	-103760	11689.76	-8.87614	2.05E-05
Per Capita(X6)	4.150607	0.114021	36.40213	3.55E-10

Year	Net Financing (Millions) (Y)	Assets (Millions) (X1)	GDP(Annual %age change) (X2)	Inflation (X3)	Population (X4)	Current account balance (X5)	Per Capita(X6)
2003	8652	12915	4.846	3.102	146.75	4.864	29,389
2004	27535	44143	7.369	4.568	149.65	1.846	30,363
2005	45786	71493	7.667	9.276	152.53	1.4	32,032
2006	65613	119249	6.92	7.921	155.4	3.948	41,856
2007	106848	205946	7.83	7.93	158.53	4.23	54,693
2008	184641	358325	8.88	7.94	161.74	4.54	71,467
2009	277153	623450	10.06	7.96	165.00	4.87	93,385
2010	413594	1084741	11.40	7.97	168.34	5.22	122,026
2011	600014	1887342	12.90	7.98	171.74	5.60	159,451
2012	731591	3283786	14.63	8.00	175.21	6.00	208,353

Abstract

It has been observed that Islamic Banks in Pakistan mostly use mark up financing on short term basis. Long term financing on profit sharing basis is avoided. One of the possible reasons of this behavior is the structural incompetence of Islamic banks. This paper analyzes whether afore mentioned observations are true. In addition to that the paper analyzes the relationship between net financing provided (by Islamic banks) and the assets of Islamic banks along with macroeconomic indicators. Data was gathered from published papers on Islamic banking, State Bank Annual Publication and survey of banking officials. The research highlights whether Mudarabah is a preferred type of finance or not. Furthermore it also analyzes the structural problem in Islamic banks which are leading to unpopularity of Mudarabah. The paper proves that Mudarabah is not a preferred mode of finance due to risk and other complexities, rather banks prefer to use short term mark up financing. Moreover there is a positive relationship between net financing provided and the assets of the Islamic banks along with macroeconomic indicators. The paper concludes that State Bank should take necessary measures for the development and modification of Mudarabah resulting in the growth of Islamic Banking Industry.

Introduction

Over the past decade Pakistan has observed a significant growth in Islamic banking. The origin of Islamic banks dates back to era of Zia-ul-Haq who brought about the Islamization of the country. However significant steps were taken by the government in 2001 for the gradual implementation of Islamic banking as a parallel system. Since then Islamic banks have shown tremendous growth which exceeds the growth of conventional banks. SBP worked on three pronged strategy to promote the Islamic banking in Pakistan; the first strategy is to allow new full fledge Islamic banks in the private sector, the second strategy is to allow the conventional banks to set up Islamic banking subsidiaries and the third strategy is to allow the existing conventional banks to open Stand-alone Islamic banking branches. The first and third options have been put into effect so far and none of the commercial banks have so far set up a subsidiary for Islamic banking.

The first Islamic banking license was granted on 31st January, 2002. As a result of the current strategy the industry has been continuously showing remarkable growth. In 2003, the country had only one full fledged Islamic bank operating and two conventional banks were operating Islamic banking branches. The total assets had a market share of about 0.5% and the total branch network comprised of 17 branches. Today (2007), the country has 6 full fledged Islamic banks operating and 12 conventional banks have Islamic banking branches. As on 30th June 2008, the total assets of the Islamic banking industry were around Rs. 229 billion which accounts for a market share of about 4.5%. The total branch network of the industry comprises of over 358 branches with presence in over 50 cities & towns and covering all the four provinces of the country and AJK.

The increase of Islamic banking can be directly related to the popularity of Islamic modes of financing amongst the masses. The Islamic modes of financing consist of Mudarabah, Musharaka, Murabaha, Ijarah, Istisna etc. However, with the popularity of the modes of financing certain problems in the practice have also taken place in their practice and application. The research paper will deal with the problems with Mudarabah application along with the analysis of the Islamic modes of financing in terms of the total financing provided by the banking sector.

Literature Review

The progress of Islamic banking in Pakistan has been constrained by an interrelated network of regulations, the roots of which, it is argued, are in the lack of operating Islamic ethical norms in the business environment, *(Mohsin Khan & Abbas Mirakhor, 1990)*. The financial sector must be allowed reasonably free and efficient access to the market so that it can receive proper expected rate-of-return signals and translate these signals into rates of return for its depositors *(Mohsin Khan & Abbas Mirakhor)*. Most of the financing provided by the Islamic banks do not conform to the principle of profit-and-loss sharing. Instead, much of these financing activities are offered through debt-like instruments. The banking community has also shown a reluctance to engage in medium- or long-term industrial financing on a profit-sharing basis i.e. Mudarabah & Musharakah *(Mohsin Khan & Abbas Mirakhor)*. Majority of banks financial transactions were directed away from agriculture and industry and towards trade and retail financing due to the high risk resulting from asymmetric information, and high corruption. Islamic banks in Pakistan rely much more on short term mark up system than on long term profit sharing system *(Rajesh K Agarwal & Tarik Yousef, 2000*). For reasonable level of moral hazard, Islamic banks have preferred mark up over profit sharing *(Rajesh K Agarwal & Tarik Yousef, 2000)*. On average Murabaha represented 54.42% of the total financing and investment portfolios of given Islamic banks in 2004-2006 (Islamic banking sector review, 2003-07). Mudarabah still remains as high risk method of financing and sophistiatsed credit risk evaluation is conducted before signing of the contract *(imtiaz pervez, 1990)*. While there have been significant advances in the development of the theoretical foundations of Islamic banking and finance, many important issues are as yet unresolved *(Mohsin Khan & Abbas Mirakhor)*.

Mudarabah is a kind of partnership, wherein one party provides finance to other for the purpose of carrying on trade- the party who provides the finance, is called "Rabb-ul-Mal", whereas the other party who actually works for the Mudarabah is called the Mudarib *(Tanzil ur Rehman*). There are two kinds of Mudarabah; restricted Mudarabah and non-restricted Mudarabah. In restricted Mudarabah the investor decides the kind of business which will be managed by the entrepreneur. However non restricted Mudarabah gives entrepreneur the option to choose the business he wants to conduct. There are two types of Mudarabah practiced in Pakistan. The first is multipurpose Mudarabah with more than one objective while the second is a specific purpose Mudarabah with a particular purpose *(Shabbier Kazmi, 2007)*. Mudarabah can have two or more partners. Mudarabah with two partners is the simplest mode. Mudarabah with more than two partners can encounter problems when the assets are illiquid and one of the partners wants dissolution of his share *(Tanzil ur Rehman)*.

It has been observed that the application of Mudarabah is not in accordance with the theory. In most cases the scope of the application of *Mudarabah* has not been defined *(Hasanuz Zaman)*. The concept of *Mudarabah* Certificate is also to be found in Pakistan for financing short-term and medium-term requirements of different sectors of the economy. However, the theory o f Mudarabah suggests that it is applicable to simple businesses and trades e.g. simple purchase and sale *(Hasanuz Zaman)*. This approach if rigidly applied will exclude modern trading operations in which presale processing and after sale service is also involved *(Hasanuz Zaman)*.

As observed by the classical jurists of Mudarabah contract relates to the business, i.e. sale and purchase of merchandise *(Tanzil ur Rehman)*. The capital of Mudarabah cannot be in an industry or agriculture *(Tanzil ur Rehman).* However in the modern context, the concept can be extended and applied to the project/ industry so long as the principles of Shariah are adhered to *(Tanzil ur Rehman).*

Research Objectives

The main objective of our research paper is to bring to light the differences in theory and practice of an Islamic mode of finance: Mudarabah. The theory part will include the explanation of the process of Mudarabah. It will analyze whether Mudarabah in practice is actually based on the Islamic theory or whether it is practiced differently Furthermore, it will include the analysis of the complexities of profit sharing ratio development. In the end the paper will recommend institutional arrangements to overcome the difficulties and make it more popular among the borrowers and financiers

It will look into the implementation of Mudarabah in Islamic banks and the reasons of its unpopularity. This leads to our first hypothesis

1. ***Mudarabah is not a preferred mode of finance due to the complexities involved in its application.***

Our research also aims to highlight the relationship between financing provided and the growth in assets of Islamic banks. Macroeconomic factors such as GDP growth rate, inflation, per capita income and other such variables will be used to refine our analysis. This leads to our second hypothesis:

2. ***a) Growth in Islamic finance is directly related to growth in assets of Islamic banks***

   b) Islamic finance will grow over the years but most of the growth will take place in modes of finance other than Mudarabah

It is observed from the Islamic banking sector review that with the growth of assets the financing provided is also increasing over the past 4 years. Our research will analyze this growth pattern in relation to macroeconomic indicators.

Our third hypothesis is:

3. ***Islamic commercial banks are not structurally capable of offering Mudarabah***

Islamic banks in Pakistan are more involved in the commercial activities and are not inclined towards investment banking. Therefore we see a dearth of Islamic investment banks. This behavior can be reinforced by the fact that Islamic banks are more involved in providing short term finance to less risky projects. The paper will analyze the structural problems of Islamic banks in relation to Mudarabah financing.

Methodology & Data

Sources of Data

The two methods of collection data; Primary and Secondary; both have been employed to collect data for the research.

a) ***Primary Data***

Our primary source of data collection was survey. In a sample size of 30 a survey was being conducted in which questions regarding our first hypothesis were asked. The questionnaire is attached in the annexure of the research paper.

b) ***Secondary Data***

The secondary data was for the research was taken from different published research papers related to our topic. The referencing of these papers has been mentioned in the bibliography. Moreover, data for the recent years has been taken from State Bank Publications. Our survey had only one question resulting in nominal data (multiple choice, single-response)

Methodology

We have employed both the qualitative and quantitative techniques for the analysis.

a) ***Qualitative Analysis***

Our qualitative analysis is based upon the analysis of survey that we conducted to prove our first hypothesis. In addition to that SBP publications such as Islamic Banking Sector Review, Strategy for Islamic Banking and SBP Annual Reports have been used to analyze the current situation of Islamic banks in Pakistan.

b) ***Quantitative Analysis***

For the quantitative analysis we have used **ANOVA** technique. The regression of the macroeconomic indicators, net financing provided by the Islamic Banks and their assets has been carried out. This method has been specially used to prove our second hypothesis.

We have taken one dependent variable (Y) that is ***'Net financing provided by the Islamic Banks'*** and six independent variables consisting of one variable as ***'Net Assets of Islamic Banks (X_1)'*** and five macroeconomic indicators such as '***GDP-Annual Percentage Growth (X_2), Inflation – Annual Percentage Growth (X_3), Population in millions (X_4), Current account balance (X_5), Per capita income (X_6)'***. The forecasted figures of the net financing provided by the Islamic Banks for the next five years (2007 onwards) were taken from SBP's Strategy for Islamic Banking. However, we have calculated the forecasted figures for the other independent variables using the "Constant Annual Rate of Growth Model", assuming annual compounding by using the formula:-

$$Y_t = Y_o (1 + \text{growth rate})^t$$

Analysis

Hypothesis 1

i. Risks

The literature review as well as the survey of bank officials has revealed that the basic problem of Mudarabah contract is the high level of risk involved. For the Mudarib the major risks are of bank failure and the uncertainty regarding the level of profits to be shared. Another serious problem with *Mudarabah* is that there is no guarantee that the bank will get their funds repaid. Furthermore the risk of getting no profits for a long time is considerable, especially with the type of small businesses that characterize our economy. Due to weak regulatory framework, there is also a moral hazard problem, as businesses can potentially camouflage the profits they made to minimize the profits shared. This is very common in SME's where formal audits are not required.

Mudarabah is a long term contract and profits take a long time materialize. For Mudarib, the profit sharing ratio (usually not more than 10%)[1], is not much incentive for him to exert his

[1] Mudarabah association of Pakistan

efforts and hard work into the enterprise. Mudarib would rather work on Ujrat-e-Misl, where at least his compensation is fixed and definite.

Mudarabah, being a long term contract, has high risk of failure. As can be observed by sate bank's annual report, the NPL: Loan ratio has increased significantly (Figure: 2) and now stands at 6% (est. 2007-08). Islamic commercial banks in Pakistan are not well equipped to calculate the risk and charge an appropriate risk premium. Risk management framework was introduced only last year i.e. 2008, and is still being implemented. Due to the lack of risk management in Islamic banks we observe avoidance of issuing long term finance on PNL sharing.

ii. Hedging of Risks

Islamic banking practice is highly exposed to interest rate, liquidity and non-payment risks. Unfortunately, conventional risk management techniques could not be used at Islamic banks as they are un-Islamic. There is a serious dearth of Islamic hedging instruments which has led to a greater focus of Islamic banks on short term less risky investments. There is a need for risk analysis and risk-management tools to provide Islamic banks with hedging instruments to hedge against the high volatility in the market.

iii. Scope of Mudarabah

In the view of certain jurists e.g. the Shafaii's, Mudarabah is only restricted to trade operations i.e. buying and selling. Conservative jurists believe that this scope cannot be extended to other businesses such as agriculture or industry. This limits the use of Mudarabah in modern businesses.

iv. Lack of trained personnel

Our survey has revealed that the major reason of avoidance of Mudarabah as a mode of finance is the lack of trained professionals in Islamic banks (Table: 5). 80% of the professionals have been hired from conventional banks and thus their technical competence is limited to conventional banking. They do not have the capability to analyze an investment, calculate the risk and the profit sharing ratio in an Islamic context. Islamic banks are more inclined towards offering commercial/ consumer products e.g. mortgage loans, car lease, mark-up financing.

v. Inconsistent Shariah Compliance & Implementation

One of the biggest deterrents in Mudarabah's popularity is the inconsistency of Shariah implementation across different Islamic banks. There is a lack of uniformity and standard. Every Islamic bank has its own Shariah board and Shariah advisor resulting in different forms of the same product. This is also puts a limit to the use of long term finance based on PNL, because the different versions of the product in the market discourage the entrepreneurs. Moreover, there is a lack of a standardized regulatory framework and there is no check as to the conduct of banks. There is a growing need to improve governance at Islamic banks. The corporate governance framework and regulatory framework are still under process at the Islamic banking department of SBP.

vi. Business Ethics

Pakistan is one of the top ranked countries in corruption. Corruption is visible in every walk of life, banking included. Banks are wary of lending credit on long term basis because of the fact that most of the individuals in our country are inclined towards corruption and rent seeking attitude. On other hand entrepreneurs face the nepotism and red tape-ism in banks, when applying for a long term loan. Lack of business ethics is a major problem that has led to unpopularity of Mudarabah.

vii. Dearth of Long term Shariah-Compliant Investment Tools and Avenues

The 'Shariah Board' of Islamic banks consists of a small bunch of competent Shariah experts who do not keep in mind the changing market needs and demands. They have little insight into the complexities of present-day financial markets. Therefore we see products still being offered, that were developed decades ago. Members of the Shariah boards are not dynamic and have not developed modifications in the old products. Considering the changing paradigm, it is imperative for the Shariah board to come out of the shell and develop new Shariah compliant tools.

viii. Imitation of Conventional Practice

It has been observed that Islamic and conventional banks are operating in a competitive setting. Therefore we see that most of the Islamic products such as mark up and leasing are imitations of debt like instruments with mark-up/ rent being charged on the same interest rate as the conventional banks. The profit sharing ratio of Mudarabah is also equivalent to the interest rate charged by conventional banks. This behavior has completely eroded the essence of Islamic banking and the trust of consumers.

According to the Islamic banking sector review, the share of Mudarabah in the finances issued by Islamic banks was only a negligible 0.3% (Figure: 4). On the other hand the share of finances issued on the basis of Murabaha and Ijarah were 44.5% and 24% respectively. This percentage share and afore mentioned reasons clearly indicate the preference of short term financing over long term financing. This proves that '***Mudarabah is not a preferred mode of finance due to the complexities involved in its application'.***

Hypothesis 2

Rather than taking multiple regressions we have taken single variable regression of each independent variable with the dependent variable. The linear equation obtained after taking the regression of Net assets(X_1) with Net financing(Y) is;

$$Y= 68003.21 +0.23191(X_1)$$

This proves that with a unit increase in the value of 'X_1', the value of 'Y' will increase by 0.23 units. This shows direct relationship between the net assets and net finances. The value of 'R' Square is 0.929. This proves that the model is quite significant and that 92.9% variations in the dependent variable are due to the independent variable. This shows that growth in assets of Islamic banks will lead to a growth in financing provided by them.

The linear equation obtained after taking the regression of GDP (X_2) with Net financing(Y) is;

$$Y=-523563+83209.53(X_2)$$

This proves that with a unit increase in 'X_2' the value of 'Y' will increase by 83209.53. This shows direct relationship between the GDP and net finances. The value of 'R' square is 0.945. This proves that the model is quite significant and that 94.5% variations in the dependent variable are due to the independent variable. A higher GDP growth rate depicts development of the economy which directly relates to the financing available to businesses. Our regression proves the fact that with a higher GDP growth rate, net financing provided by Islamic banks will increase.

The linear equation obtained after taking the regression of Inflation (X_3) with Net financing(Y) is;

$$\boldsymbol{Y=-133386+52242.8(X_3)}$$

This proves that with increase in 'X_3' value by one the value of 'Y' will increase by 52242.8. This shows direct relationship between the Inflation and net finances. The value of 'R' square is 0.14. This proves that the model is not significant. Inflation brings along a greater need of financing by businesses to maintain their working capital and increasing cost of doing business. Thus the net finances provided by Islamic banks will increase with inflation. This phenomenon has also been observed in the present year (2008) too. Financing provided in 2007 was PKR 2191 billion as against financing provided in 2008 which stood at PKR 2594.6 billion (Table 6).

The linear equation obtained after taking the regression of Population (X_4) with Net financing(Y) is;

$$\boldsymbol{Y=-3818462+25326.38\ (X_4)}$$

This proves that with unit increase in 'X_4' the value of 'Y' will increase by 25326.38. This shows direct relationship between the Population and net finances. The value of 'R' square is 0.89. This proves that the model is quite significant and that 89% variations in the dependent variable are due to the independent variable.

The linear equation obtained after taking the regression of Current Account (X_5) with Net financing(Y) is;

$$\boldsymbol{Y= -268055 + 120936.5\ (X_5)}$$

This proves that with unit increase in 'X_5', the value of 'Y' will increase by 120936.5. This shows direct relationship between the Current account deficit and net finances. The value of 'R' square is 0.51. This proves that the model is not appreciably significant and that only 51% variations in the dependent variable are due to the independent variable.

The linear equation obtained after taking the regression of Per capita (X_6) with Net financing(Y) is;

$$Y = -103760 + 4.15 (X_6)$$

This proves that with unit increase in'X_6', the value of 'Y' will increase by 4.15. This shows direct relationship between the per capita income and net finances. The value of 'R' square is 0.99. This proves that the model is highly significant and that only 99% variations in the dependent variable are due to the independent variable.

The regression proves that ***net finances are expected to rise with net assets of Islamic banks and macroeconomic indicators***. The popularity of Islamic modes of financing will increase in future and more people will adopt them. However, this holds true for Islamic modes of financing such as Musharakah, Murabaha and Istisna etc. because according to the review of SBP, currently the share of Mudarabah is only **0.23%** (Figure 4)**.** The future growth of Mudarabah seems quite insignificant unless and until SBP takes significant measures for the development of Islamic Banking Sector.

Hypothesis 3:

Our survey result shows that the structure of most Islamic banks lacks the essential investment analysis department. Islamic banks in Pakistan are more oriented towards offering commercial/ consumer products. However to offer long term investment loans such as Mudarabah banks need to have a separate investment analysis department. This department is vital if Islamic banks want to offer Mudarabah as a mode of finance. However, as of present, the banks are lacking this department and therefore are structurally incapable of offering Mudarabah. Since they do not have such a department, therefore they evaluate the profitability and risk of the investment at hand. This proves our third hypothesis; '***Islamic commercial banks are not structurally capable of offering Mudarabah'.***

Conclusion

This research paper proves that Mudarabah is an unpopular mode of finance due to the risk and other complexities involved. Personnel at Islamic banks are not capable of dealing with complexities of Mudarabah and therefore they prefer mark-up financing over profit sharing financing. It also proves that Islamic banks are not structurally suitable to offer Mudarabah, since they lack a separate investment analysis department. Furthermore the research proves that there is a positive relationship between net financing provided by Islamic banks, assets of Islamic banks and macroeconomic indicators.

Limitations

This paper does not take into consideration the use of Mudarabah by Islamic banks for moving investment deposits. It only focuses on its financing the business aspect. Also we will follow the view of Mudarabah that is taken as standard in the current literature, although there are several variants of the concept by different scholars. This paper does not recommend any improvements in the profit share calculations in Mudarabah. It only analyzes the complications in profit ratio development due to risk factor. This paper specifically analyzes Mudarabah, however, other modes like Musahrakah, Salam and Istisna are not taken into consideration.

Future Outlook

Promoting Mudarabah as mode of finance is necessary for the development of the country. This promotion will lead to greater access to funds to entrepreneurs and flourishing of businesses. However, before we paint a beautiful picture, it is imperative to ensure that a proper risk management framework is developed and implemented in all Islamic banks. State Bank of Pakistan has taken initiatives in this regard and has developed a risk management framework which was sent to all Islamic banks in September 2007 (Table: 2). State Bank should make sure that all banks are complying to the standards of risk management. Furthermore, a standard regulatory framework also needs to be in place. State Bank plans to roll out corporate governance standards for Islamic banks in June 2009 (Table: 2). Apart from the regulations, it is imperative to train human resource in Islamic banking so that they can be effective managers. State Bank has a plan to establish a specialized institute; Institute of Islamic Banking and Economics, to develop Human Resource for the industry which is required to run this industry on a sustainable basis. There is a strong need to develop a larger number of Shariah experts of high professional prudence and integrity which can develop a diversified range of products and hedging tools and modify the existing ones to suit the market conditions. A Central Shariah Board needs to be in place to ensure homogenous products across the Islamic banking industry and compliance with the Shariah rules. Last, but not the least, SBP needs to separate investment institutions from commercial banking, making investment institutes an independent enterprise.

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