

## Problem of Agency in *Mudarabah* Contract

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### Abstract

This study evaluated agency problem in *mudarabah* (profit sharing) contract and suggests some prudent and comprehensive mechanisms to mitigate this problem from Islamic perspectives. Agency problem in *mudarabah* contract can cause a number of difficulties if there is no effective information transfer between the contracting parties. Full disclosure of information from the entrepreneur (agent or *mudarib*) that manages the fund on behalf of a capital provider (principal or *rabbulmaal*) can help to reduce misinformation and assist decision making. Some approaches that can be taken to avoid asymmetric information are compatible incentive contract, screening and monitoring process, *shuratic* (social learning) process and execution of Islamic code of conduct. This study highlights the roles of the Islamic code of conduct and *shuratic* process in mitigating agency problems in *mudarabah* contract.

**Keywords** Profit loss sharing; asymmetric information; optimal contract, Islamic code of conduct *shuratic* process

### Introduction

*Mudarabah* (profit sharing) contract is a novel Islamic financing vehicle that has been applied since the pre-Islamic era. This financing approach is an alternative to conventional debt financing mechanism. Note that conventional debt financing involves interest rate. In current financing sector, *mudarabah*

is not as employed as other Islamic financing approaches such as *murabahah* (cost-plus financing) and *bai' bithaman ajil* (deferred payment sale). This is because there seems to be a higher rate of agency problem in *mudarabah* financing compared to other types of Islamic financing. Consequently, Islamic banks and investors tend to avoid *mudarabah* as their financing vehicle.

Moving on, agency problem in *mudarabah* contracts are mainly caused by the entrepreneur (*mudarib*) who manages the *mudarabah* fund. An entrepreneur has complete control of the agreed project. He also has more information on the project and its performance. Such information is not accessible to the Islamic banks, which is also the capital provider. From this, it can be seen that the agency problem is caused by asymmetric information between the contracting parties. Such unbalanced information access can generate two major problems; adverse selection and moral hazard. This will complicate the process of achieving an optimal contract (Hoppe & Schmitz, 2018; Hirofumi et al., 2017; Rowell et al., 2017; Piskorski & Westerfield, 2016). An optimal contract is a contract between two or more parties that minimizes the costs as much as possible for all parties involved that consists of terms and conditions that are agreed by them. Following these disadvantages, Islamic banks tend to avoid offering *mudarabah* contract as one of their products. This study hopes to provide some recommendations on reducing agency problems and increasing profit returns for contracting parties in *mudarabah* contract.

This report is made of four sections. In Section 2, there will be a brief review of the agency problem that occurs in *mudarabah* contract. Meanwhile, Section 3 outlines the indicators that may mitigate agency problem in *mudarabah* contract. The study is concluded in Section 4.

### **Financing Contract and Asymmetric Information in Islamic banking**

#### *Financing Contract in Islamic banking*

The Islamic financial system offers an alternative to conventional financing. There are two main divisions of contracts for Islamic banking, which are equity-based and debt-based contracts. Equity-based contract in Islamic financing emphasizes on profit sharing method. As frequently mentioned in *fiqh* literature, equity-based contract can be divided into two types; *mudarabah* (profit sharing) and *musyarakah* (profit and loss sharing) contracts. These contracts are based on the Islamic teaching that requires any business transaction to be executed fairly for all parties involved. In *mudarabah* contract, the capital provider (*rabbulmaal*) deserves a share of the profits. The profits are counted as a compensation for the provided capital. Meanwhile, the entrepreneur as a provider of skill and labour deserves a share of the profits for his efforts in generating profits through business ventures. On the other hand, in *musyarakah* contract, the contracting parties agree to conduct the business ventures collectively. The parties involved in *musyarakah* contract will contribute capital in the form of monetary or non-monetary assets. Also, the profit share and distribution of losses will be determined before the execution of the contract.

Moving on, the inefficiency in the dissemination of information among the contracting parties in equity-based contract contributes to asymmetric information. Asymmetric information is a situation where a capital provider (principal) has insufficient knowledge of the actions and decisions taken by his counterparties (agents) involved in the venture. This asymmetric

information will generate adverse selections and moral hazard problems. Adverse selection is the ex-ante asymmetric information problem that occurs before the transaction happens, while moral hazard is the ex-post asymmetric information problem that occurs after the financial transaction takes place. The principal who fails to protect himself from adverse selection and moral hazard problems will face some difficulties in escaping a poor investment. He may also face great losses in the future.

The adverse selection problem is also referred to as hidden information problem. This problem is caused by the principal having lesser information on the project than the agent. There have been many cases showing that agents may have a motive to lie about himself. For example, an agent may lie about his background, experiences, and abilities to execute the project before the contract is signed. Once this person is selected to run the investment, there is a strong possibility of an undesirable outcome. This risks can cause bad credit for the principal. Fortunately, having a contract that can prevent dishonesty will solve this problem. We will discuss this issue further in this paper. Apart from that, moral hazard often occurs after the contract is executed. In such situation, the agent uses the private information available to him to his advantage. When this happens, an agent who engaged in risky, immoral activities may hinder the principal from achieving his business objective. Such action will also reduce the probability of the borrowed funds being repaid to the principal.

The agency problems in the equity-based contract have been continuously discussed by Islamic scholars. Many of these scholars encourage individuals to implement equity-based instruments to avoid *riba* (interest) and *gharar* (uncertainty) and to promote the spirit of brotherhood. According to Khoustem and Nedra (2012), equity-based financing has some advantages over the interest-based system.

Firstly, equity-based financing engenders a macroeconomic stability through a sound and less vulnerable financial system. This system ensures the sustainability of financial intermediation and boosts economic growth. On the other hand, the interest-based system is subjected to instability and is volatile to economic distress (Zeineb & Mensi, 2014). Abdul Karim et al. (2017) agreed with this when they revealed the mean z-score of both Islamic and conventional banks in the Gulf Cooperation Council (GCC) countries. The scores were low during financial crisis, suggesting that the stability of both banks were affected by this crisis. The stability of the Islamic banks (1259.3) was higher than the conventional banks (445.9), with the t-test and the Wilcoxon Mann-Whitney test significant at 1% ( $p=0.01$ ). This proves that Islamic banks are more stable than conventional banks during crisis period.

Moreover, Islamic finance encourage the application of equity-based financing arrangements that adheres to social justice and equity in transaction. In these arrangements, investors share both gain and losses, while those who provide capital become investors, rather than just creditors. equity-based financing encourages entrepreneurship and wealth creation and encourages equitable, stable economic development (Zeineb & Mensi, 2014). In addition, Islamic banks are more asset-based and are more focused on “risk sharing” compared to conventional banks (Sapuan et al, 2016; Hasan & Dridi 2010).

Secondly, equity-based financing promotes projects profitability than credit-worthiness. This is similar to the conventional system. Such focus encourages the acceleration of capital accumulation, reinforces real wealth creation, and strengthens growth especially for Islamic financial system. Thirdly, equity-based financing is socially responsible. This system selects projects with high social benefits and forbids the unethical use of funds that may cause

equitable distributions of resources without hindering individual liberty.

Despite these advantages, the equity-based contract is still less favoured by financial institutions compared to other Islamic debt-based contracts. This is due to agency problems. The data supporting this unfortunate claim can be seen in Table 1.

Table 1: Types of Financing in Islamic banking, Malaysia from 2006 to 2017 (RM million)

Types of contract	2006	2008	2010	2012	2014	2017
<i>Bai Bithaman Ajil</i>	29,845.0	34,518.9	53,697.4	74,280.6	79,783.2	65,465.0
<i>Ijarah</i>	762.9	2,774.1	3,940.2	4,635.7	7,677.8	10,308.8
<i>Ijarah Thumma Al-Bai</i>	21,470.4	31,847.2	43,497.4	54,574.7	67,253.2	71,401.4
<i>Murabahah</i>	5,300.9	15,854.8	23,296.9	40,018.4	83,842.7	190,543.9
<i>Musyarakah</i>	156.8	1,134.6	3,958.3	11,832.2	23,113.1	48,459.5
<i>Mudharabah</i>	147.9	312.9	275.8	142.2	77.3	61.0
<i>Istisna'</i>	509.4	1,384.2	1,621.0	989.3	1,016.7	1,951.0
Others	15,174.9	16,803.4	28,924.1	46,324.7	71,417.9	93,056.6
Total Financing (RM million)	73,368.1	104,630.1	159,211.0	232,797.8	334,181.9	481,247.3

(Sources: Bank Negara Malaysia, 2018)

Table 1 shows the financing activities of Islamic banking system in Malaysia from 2006 to 2017. The data demonstrate that *bai' bithaman ajil* (deferred payment sale), *murabahah* (cost-plus financing), *ijarah* (leasing) and *ijarah thumma al bai'* (hire purchase) dominate Islamic financing system. For example, in 2006, *bai' bithaman ajil* encompassed 40.7% of the total financings in Islamic banking system, with the value of RM29, 845 million. This figure increased to RM65,465.0 million in 2017 but at a decreasing as compared to year 2012 and 2014. There was also an upward trend in the *murabahah* financing – from RM5, 300.9 million in 2006 to RM190,543.9 million in 2017. Meanwhile, profit loss sharing (*musyarakah*) and *mudharabah* did not bring as much revenue as other types of Islamic financing. As discussed earlier, this may reflect the institutions fear of loss caused by asymmetric information. The *mudharabah*

financing shows a decreasing trend. The profit decreased from RM312.9 million in 2008 to RM77.3 million in 2014, and to RM61.0 million in 2017. In contrast, the trend for profit loss sharing (*musyarakah*) financing increased from RM156.8 million in 2006 to RM48,459.5 million in 2017, especially with the introduction of *musyarakah mutanaqisah* that is currently offered by most Islamic banks. Meanwhile, other types of financing such as *bai' al inah* (sale and buy-back), *bai' al-tawarruq* (commodity murabahah) and *al-rahn* (pawn broking) showed an increasing trend from RM15,174.9 million in 2006 to RM84,616.9 million in 2017.

### **Agency problems in *mudarabah* contract**

The agency problems is a standing issue in finance and have been studied by Jensen and Meckling (1976). The agency relationship exists when one party (the principal) engages another party (the agent) in running a business on their behalf. In this context, the principal will delegate some decision-making authority and risk-bearing function to the agent. An agency problem occurs when there is a conflict of interest between investors (principal) and the managers of the project (agent). This is especially true when the managers want to manipulate the returns of the project. Also, these managers may be looking for a way to serve their own agenda without considering the principal's interest. As aforementioned, this may lead to adverse selection and moral hazard problems.

In Malaysia, Islamic financial institutions prefer debt financing products such as *murabahah* (cost-plus financing) or *bai' bithaman ajil* (deferred payment sale) for their business activities than equity financing (profit sharing and profit loss sharing) contract. Agency problems are the main reason for equity financing becoming less popular than other financing methods. Under the equity contract, the entrepreneur (*mudarib*) often has more information about the proposed project and its profitability. Such information is not usually accessible to the

Islamic banks (*rabbul maal*). This leads to lopsided information between the contracting parties. An early study by Holmstrom (1979) on the bilateral relationship between the capitalist (principal) and the manager (agent) in investment projects showed that agency problems occur due to asymmetric information, unbalanced risk sharing and lack of supervision.

In a *mudarabah* contract, profit and losses will be shared between the contracting parties. This is consistent with the "no profit sharing without the risk-sharing" (*al-ghunm bi'l-ghurm*) and "profit bearing risk" (*al-khraj bi'l daman*) principles. These principles encourage risk sharing and cooperation between the contracting parties since both parties are assumed to have similar interests in the welfare and soundness of the project. This is consistent with the theoretical findings of studies conducted by Siddiqui and Fardmanesh (1992), Presley and Sessions (1994) and Bashair and Darrat (1996) who discovered that *mudarabah* contract has the potential to be an efficient investment vehicle in the Islamic financial system.

Nevertheless, *mudarabah* contracts have high risks. As mentioned earlier, the entrepreneur (*mudarib*) has an access to valuable information that is unaccessible to the Islamic banks. This caused asymmetric information among the contracting parties (Siddiqui, 2008). Moreover, Ismail and Tohirin (2008) and Khalil et al. (2002) discovered that *mudarabah* venture may be unproductive. This usually happens when Islamic banks fail to execute an effective screening process in selecting suitable managers and do not monitor the entrepreneur's activities after the contract has been signed.

Due to the agency problems, the implementation of equity financing instruments is not as highly sought as debt-driven instruments. Most financiers feel safer to transfer the risk of investment to the manager of the venture through debt financing rather than sharing the risks of investment with them. Tag El-Din (1992), Aggrawal and Yusef (2000), Dar

and Presley (2000), and Pratomo and Ismail (2006) agreed with this when they reported that debt financing was preferred by most financial institutions compared to equity financing.

### **Mechanisms to Mitigate Agency Problems from the Islamic Perspective**

One of the most pertinent ways in mitigating agency problems is full disclosure among the contracting parties. This includes information regarding how the capital is used, the objective of the principal/agent and current performance of the venture. This study reported four tools that have been proposed and recognized by the Islamic scholars to resolve the problem of asymmetric information in *mudarabah* contracts. The tools are explained below:

#### **Screening and Monitoring Process**

Many Islamic scholars (Abalkhail & Presley, 2002; Ismail & Ahmad, 2006) encourage the use of the screening process to alleviate the adverse selection problem. The wrong selection of entrepreneur may worsen the problems and cause the project to fail. Therefore, to determine the optimal utilisation of the *mudarabah* fund by the entrepreneur, a comprehensive screening system should be implemented before the contract is signed.

Furthermore, additional monitoring and supervision are important in reducing information asymmetry ex-post. Nevertheless, this will generate additional operating costs – the deadweight costs. This will cause Islamic banks to be considered incompetent in comparison to the conventional banks (Sadr & Iqbal, 2002). Following this, Sadr and Iqbal (2002) suggested that the extra cost for close monitoring and supervision should be viewed as an investment to acquire more information about the entrepreneurs and the investment project. Additional monitoring may provide three advantages. Firstly, better monitoring and closer supervision may overcome agency problems. Secondly, stronger supervisions

provide more information on the condition of the market and the environment for further research. Thirdly, a more diligent supervision can provide further insights into the industry or the region where the resources are invested. From there, firms will be able to have a more accurate estimation of the possible profits.

After the project has been executed, there may be more serious agency problems. This is particularly true if the principal fails to monitor the agent's actions, especially when the entrepreneur possesses superior information about the business environment (Grossman & Hart, 1983). As explained by Sarker (2000), the capital provider (*rabbulmaal*) should evaluate and monitor the entrepreneur's (*mudarib*) visions, objectives, market strategy, financial strategy, and production process throughout the execution of the contract. Islamic banks can gather more information on the operations of the firm through a monitoring process (Sarker, 2000; Ahmed, 2002). Jensen and Meckling (1976) discovered that agency cost can be divided into three: 1) bonding cost, 2) monitoring cost and 3) residual cost. Bonding costs are costs that the manager takes upon himself to reduce agency conflict. These efforts require no monitoring process and are undertaken at the expense of his own utility. Meanwhile, monitoring cost consists of costs directly related to the principal's monitoring of the agent's behavior. On the other hand, the residual cost is established from the depreciation of the asset value. This may be caused by the conflict between the agent's decisions and decisions that may maximize the welfare of the principal.

#### **Incentive Compatible Contract**

A contract is designed to ensure mutual benefit for both contracting parties. The entrepreneur (*mudarib*) is assumed to have superior information to Islamic banks (*rabbulmal*). This is because the entrepreneur is able to observe the productivity of the project before committing to the investment. Only he can see his own effort in managing the investment. Since his observations

and efforts are of private information, the manager cannot be compensated directly for its provision (Anwar and Haneef, 2005). One way to overcome this dilemma is by designing an incentive contract.

Based on the incentive contract, the principal will pay the agent for carrying out risky decision making, and the principal will receive a return profit for investing in that venture (Holmstrom, 1979; Grossman & Hart, 1983; Sarker, 2000; Ismail & Tohirin, 2010). As demonstrated by DeMarzo and Fishman (2006), in static theory, cash incentives can be used to reward an agent's good performance. Meanwhile, in a dynamic setting, the agents should be rewarded with a higher share of future cash flows if he succeeds in the venture. According to Cvitanic and Xing (2018), optimal contract can be achieved if the incentive is compatible. This will motivate the agent to perform the task assigned by the principal to the best of his ability.

It should be noted that investments through *mudharabah* contracts are extremely risky as profits are not confirmed. Therefore, Presley and Sessions (1994) and Ahmed (2002) proposed the implementation of incentive-compatible contracts to allow a more efficient information disclosure between the contracting parties. For example, incentive payment through bonus shares encourages the agent to perform well. This contract becomes a tool to safeguard the terms of contracts agreed by both parties. Information regarding the true characteristics of the entrepreneurs, the objective of the Islamic banks and the performance of the venture, must be transparent to the contracting parties to ensure efficient management. This will contribute toward a higher turnover of the projects (Sarker, 2000).

Moving on, Islamic banks can impose certain incentive-compatible restrictions to ensure honest reporting (Presley & Session, 1994; Karim, 2002). Through these constraints, the entrepreneur is systematically required to adhere to the rules to maximize profit for both parties.

Karim (2002) proposed four types of incentive compatible constraints. Firstly, a higher stake in net worth or pay collateral. When an entrepreneur has a higher stake in his net worth, he will be less likely to jeopardize the business. Islamic banks can also require the entrepreneur to maintain certain holdings of certain assets relative to the business size, keeping its net worth high. Another approach to the same idea is to require the entrepreneur to provide some collateral, even when it is not compulsory for a *mudharabah* contract. In the case of misconduct by the entrepreneur, a collateral is important to protect the Islamic banks from losses. Secondly, the Islamic banks may instruct entrepreneur to get involved in projects with lower operating risk to reduce the possibility of failure. This is due to findings from previous literatures where high operating risk firms will leads to higher leverage especially with the existance of agency problem in the firm operation. Thirdly, Islamic banks may require the entrepreneur to engage in projects with low unobserved cash flow, where this decision can minimize the asymmetric information. Business with low cash flow will ensure the entrepreneur's transparency in declaring profits. Lastly, Islamic banks may encourage entrepreneurs to be involved in projects with low non-controllable cost. This is to ensure that the project can generate better profits without any unpredictable cost beyond the entrepreneur's control. Examples of such situation are the implementation of a new r minimum wage and an increase in the inflation rate.

### **Islamic Code of Conduct**

Islam has provided mankind with a perfect code of conduct mentioned in the Quran and Hadith. This code of conduct is the main guideline for Muslims' value system and is the way of life for devoted Muslim.

*"Indeed, the religion in the sight of Allah is Islam"*

(Surah Al-Imran: 19)

In term of Islamic economic practices, risk and uncertainty can be mitigated through good ethics. The Quran promotes trustworthiness (*amanah*) and insists on fairness and justice in economic and business activities. Allah (S.W.T) commands such principles to generate harmony among mankind and to achieve *Maqasid al Shariah*.

As a Khalifah (vicegerent) on this earth, we need to strictly adhere to the Islamic codes of conduct in all our activities. From the Islamic viewpoint, the development of all contracts is witnessed by Allah. Therefore, the requirement of *sighah*, the contracting parties and the subject matter of the contract should be religiously lawful and implemented according to the prerequisite stated in the al-Quran and Hadith. As one of the contracting parties, a truthful Muslim should have good ethics when executing a contract. Fulfilling promises is a highly significant ethic that should be held by a faithful Muslim. These values are closely related to good conducts that must be sustained by a Muslim. This conducts consist of intention (*niyyah*), sincerity (*ikhlas*), justice ('*adil*), benevolence (*al-Ihsan*), and trustworthiness (*amanah*).

Basically, intention (*niyyah*) is the pillar of worship and the essence and foundation of action. In Islam, there is no act that can be accomplished without a clear intention or objective. The intention must be inherent in any action and this will determine whether such action is good or blameworthy. All actions taken by a Muslim must be established with the intention of seeking the blessing of Allah. Meanwhile, sincerity (*Ikhlas*) is a very significant virtue. One cannot genuinely perform a task merely for the sake of completing it without any sense of sincerity. When a person is sincere in undertaking the task in hand, he would ensure that the task is completed to the best of his ability. On the other hand, compassion (*al-Ihsan*) is the traits that encourage the right conduct, kindness, efficiency, and proficiency. These are fundamentally meant to benefit others. It also means doing good, forgiving and helping

a person in times of need without expecting anything in return from him. *Ihsan* is related to a person's behavior of going above his own duties. This attitude will enhance the productivity of the contract that they have agreed upon.

“Do *ihsan* to parents and to relatives, orphans, and the needy.”

(*Surah Al-Baqarah: 83*)

Trustworthiness (*amanah*) enhances integrity and encourages a sound moral conduct. Being trustworthy implies that someone is being honest, fair in dealings, punctual, honouring trusts, and keeping promises and commitments. As mentioned in Koran, trust is regarded as one' duties towards God and God praises such believers by promising them paradise. Moreover, justice ('*adil*) is one of the traits and virtue of a soul. In the process of fulfilling the contract, justice is obligatory as it involves the avoidance of all prohibitions and unjust practices in the transaction and business activities. In Islam, Muslims are encourage to achieve success (*al-falah*). *Al-falah* refers to the spiritual, moral and socio-economic well-being in this world, and success in the hereafter. At the micro level, *al-falah* refers to an individual with adequate material and basic needs. At a macro level, *al-falah* aims for a full-fledged egalitarian society with freedom of human rights. In other words, Islam encourages the adherents to excel in everything that they do.

In the agency relationship based on the Islamic principle, the agent plays a role as a trustee and has an obligation to provide for the best interest of the principal and to Allah (SWT). It is vital to the agent to acquire the value of good intention (*niyyah*), sincerity (*ikhlas*) in undertaking tasks, justice ('*adil*) in implementing responsibility and trustworthiness (*amanah*) to manage the commitments and to eliminate agency problems.

In the Islamic bank's operation, the entrepreneur (*mudarib*) working on behalf of the Islamic banks (*rabbul maal*) must serve to fulfil the

interests of the Islamic banks (*rabbul maal*). This is because Allah (S.W.T) strictly instructs trustworthiness (*amanah*) and forbid dishonesty and greediness in profit-taking. These commands and prohibitions by Allah are meant to generate harmony in economic activities and to ensure justice and fairness in the transactions (Rosly, 2005). Moreover, Muslims are encouraged to strive for *al-Falah*, which embraces rewards in this world and Hereafter. Therefore, a faithful entrepreneur must be sincere with the *rabbulmal* (Islamic banks) to avoid moral hazard from asymmetric information.

### Social Learning Process

The existence of asymmetric information depends on the information transfer between the contracting parties. Lack of information transfer hinders the bank's learning process, causing them to face adverse selection and moral hazard. Without information transfer, the market would be inefficient. Therefore, it is important for Islamic banks to be aware of the action taken by the entrepreneur and of the performance of the project.

Moving on, the learning process in the production function was studied by Arrow (1962) and Stokey (1988). Arrow (1962) claimed that the learning process in the production process that was based on an endogenous theory can be achieved through experiences. The learning process in the production function can increase profits from the gross investment and labour used. Furthermore, Stokey (1988) revealed that learning strengthens existing patterns of the production process.

In a dynamic setting, learning about managerial types is important in designing a contract. Laffort and Tirole (1987) and Holmstrom (1999) explored the use of the learning process by the principal to distinguish the manager's ability and desire in managing the firm. In the dynamic stochastic environment, Jeitschko and Mirman (2002) found that the principal's ability to learn about the agent's characteristics and

the information is impeded by the course of the interaction. In addition, through the learning process, Islamic banks will be able to gain quality information about the entrepreneurs' actions and preferences. This information can assist Islamic banks in monitoring the project effectively. With better knowledge, Islamic banks can improve their ability in making decisions.

Learning is an ongoing process in everyone's life. In Islam, the quest for knowledge acquisition is a compulsory journey for all Muslims. The Holy Qur'an is very clear on the importance of acquiring knowledge and wisdom to increase self-esteem. In the Holy Quran, God has emphasized on *al-Ilm* (knowledge) more than 789 times. Among others the Holy Quran mentions:

*"Read! And your Lord is the Most Generous, Who has taught (the writing) by the pen. He has taught man that which he knew not."*

(*Surah Al-Alaq: 3-5*)

The verse above shows that Allah ordered all humans to read as a mechanism to seek knowledge. The Prophet Muhammad (s.a.w) also stated:

*"Pursuit of knowledge is a duty of every Muslim."*

(Narrated by Ibn Majan as cited in Iqbal and Lewis, 2009)

This implies that every Muslims are encouraged to pursue knowledge in the name of Allah. Such action should be done for his benefits and to be shared with the rest of the world. Knowledge should be practiced and delivered to others for everyone to appreciate the creation of Allah S.W.T.

From an Islamic perspective, the decision-making process involves consultation (*shura*) between the contracting parties. *Shura* is the

process of exchanging views through mutual consultation to produce a wise and sound decision, as explained by Choudhury (1991, 2001); Abdullah and Ismail (2014); and Sapuan et al. (2016). This process can be applied in any field that requires a consensus between two or more parties. The asymmetric information between the contracting parties in any contract that create unfairness in the distribution of outcomes can be solved through the principles of *shura*. Furthermore, the *shuratic* process can encourage the expansion of knowledge and innovation in the decision-making process (Choudhury, 2016).

The importance of *Shariah* has been stated in the Holy Qur'an as a guideline for the decision-making process:

*“And those who answer the call of their Lord and establish worship, and whose affairs are a matter of counsel, and who spend of what We have bestowed on them”*

*(Surah Al-Shura, 38)*

From the verses above, we can see that Allah (S.W.T) encourages *shura* (consultation) through extensive discussion to generate better ideas and solution. *Shura* can create a social learning (*shuratic*) process among the participants. The discourse (*shura*) requires a high degree of respect, trust, and equality. In the social learning process, the contracting parties should practice open-mindedness, respect, trust, acceptance of opposite views and the freedom to express ideas and expression (AlHabshi et al. 2008). The participants must be able to receive criticism and alternative suggestions and appreciate the diversity in talents and skills (Alhabshi et al., 1998). After the process, the participants should conduct their respective tasks and responsibilities according to the mutual agreement of all the parties involved. As mentioned by Iqbal and Mirakhor (2004) and Hasan (2009), the use of *shuratic* (social learning) process in the decision-making process may serve as a monitoring mechanism

to establish accountability, fairness, and transparency in the venture.

In current practice, the *shuratic* decision-making has been employed as one of the monitoring mechanism to attain accountability, fairness, and transparency in Islamic corporation (Iqbal & Mirakhor, 2004; and Hasan, 2009). In the *shuratic* decision-making, the manager is required to listen to any opinions and suggestions by the Islamic banks and the stakeholders. They will then diplomatically discuss and consult each other on the arising issues to find a decision agreed by the participants (Iqbal & Mirakhor, 2004). Such discussion allows for information to be disclosed and delivered efficiently from the manager to the stakeholders. Thus, this will reduce the asymmetric information in the venture. This is consistent with the spirit of Islam that emphasizes the importance of trustworthiness and cooperation among Muslims.

## Conclusion

*Mudarabah* has gone through modernisation since its inception in the pre-Islamic era. The improvement of the existing *mudarabah* conditions in the modern *mudarabah* contract is acceptable, provided that it does not contradict with the provisions in the al-Quran and Sunnah. This development is driven by the need to fulfil the requirements of the modern business community and the fast-growing Islamic financial market.

Nevertheless, *mudarabah* is less preferable compared to the Islamic debt financing instruments. The main reason why the asymmetric information problem is more severe in *mudarabah* contract compared to *musyarakah* contract is due to the exclusion of Islamic banks (*rabbulmaal*) from participating in the management of the venture. This will prevent the bank from monitoring the decisions and actions taken by the effort provider (entrepreneur or *mudarib*) i.e. entrepreneur. As a result, Islamic banks prefer to offer *musyarakah*

contract and debt-based contract. Therefore, this study specifically concentrates on the agency problems that exist in the *mudarabah* contract, especially in financing and investment activities and how to mitigate this problem.

Some of the approaches to overcome the agency problems in the financial system are to implement the Islamic code of conduct, compatible incentive contract, screening and monitoring process, and social learning (*shuratic*) process. Furthermore, the principle of *amanah* (trusteeship) has been suggested by many Islamic scholars as the main solution to reduce agency problems in *mudarabah* contracts. As a faithful Muslim, an entrepreneur needs to work in a trustworthy manner, be just, sincere and compassionate in carrying out his responsibility with the intention of obtaining Allah's blessings.

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