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THE LEGAL NATURE OF THE MUDARABA CONTRACT AND ITS REGULATORY FUNCTION WITHIN ISLAMIC BANKING LAW

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Abstract
This article examines the legal nature and regulatory function of the mudaraba contract in Islamic banking law, through a doctrinal and comparative analysis. Mudaraba (profit-sharing) is a classical Islamic partnership where one party (rab al-mal) provides capital and the other (mudarib) provides labor/management, sharing any profit per an agreed ratio while loss is borne by the capital provider. Drawing on authoritative Sunni jurisprudence (Hanafi, Maliki, Shafi'i, Hanbali) and modern regulatory frameworks, the study elucidates how classical Islamic law conceptualizes mudaraba and how contemporary legal systems incorporate it. The results detail mudaraba's juristic definition, essential conditions, and its unanimous acceptance among classical jurists as a sharikat al-amal (silent partnership). Modern civil law perspectives – including examples from Malaysia's Islamic Financial Services Act, the GCC, the UK's regulatory adaptations, and emerging frameworks in Uzbekistan – are analyzed to show how mudaraba has been recognized and modified in practice. The discussion explores mudaraba's operation in today's Islamic banking: its use in investment accounts and financing, the governance and supervision mechanisms in different jurisdictions, and challenges such as asymmetric information, moral hazard, capital guarantees, and cross-jurisdictional inconsistencies. Notably, comparative insights are provided from Malaysia, the Gulf states, the United Kingdom and other counties. Throughout, the views of prominent Islamic finance scholars – including Muhammad Taqi Usmani, Wahbah al-Zuhayli, and Muhammad al-Bashir – are incorporated to interpret doctrinal principles and

propose reforms. The article concludes with original recommendations for aligning regulatory policies with the authentic spirit of Mudaraba, aiming to enhance its viability and integrity in Islamic banking.

Keywords: Mudaraba, islamic banking law, profit-and-loss sharing, islamic finance regulation, partnership contract, shariah compliance, comparative law.

Introduction

In Islamic finance, the mudaraba contract occupies a foundational yet challenging role as a profit-and-loss sharing partnership. A mudaraba is classically defined as a silent partnership in which one party contributes capital and another party contributes labor or entrepreneurial skills. The capital provider, termed rabb al-mal, entrusts funds to the managing partner, or mudarib, who invests and manages the venture. If the venture yields profit, it is shared between them according to a pre-agreed ratio, whereas any financial loss is borne solely by the capital provider (absent misconduct by the manager) [10, p. 186]. This profit-sharing paradigm, rooted in classical Islamic jurisprudence, embodies the Shariah principles of risk-sharing and trust (amanah) in commercial dealings.

Despite its strong juristic legitimacy and ethical appeal, mudaraba has become underutilized in contemporary Islamic banking, comprising a relatively small fraction of Islamic financing portfolios [10, p. 188]. Islamic banks and investors often favor debt-based instruments (like murabaha cost-plus sales) over mudaraba due to practical impediments – notably the risks of information asymmetry, moral hazard, and lack of collateral – which complicate supervision and profitability [12, p. 27]. This retreat from profit-and-loss sharing modes raises important questions about whether current legal and regulatory frameworks effectively accommodate the mudaraba contract's unique nature. The issue is not merely theoretical: if islamic banking is to realize its distinct value proposition of equity-based, risk-sharing finance, regulators and jurists must address how mudaraba can operate securely and fairly within modern banking systems. Examining the legal nature of mudaraba, alongside its regulatory treatment across jurisdictions, is therefore crucial to understand how

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islamic law's ideals are translated (or diluted) in practice. It also sheds light on broader themes of legal pluralism and the integration of classical contract forms into contemporary civil and common law environments.

This study pursues several interrelated objectives. First, it provides an in-depth doctrinal analysis of the legal nature of the mudaraba contract as conceived by authoritative classical Sunni jurists from the four schools (Hanafi, Maliki, Shafi'i, Hanbali). By elucidating the contract's defining characteristics and conditions in classical jurisprudence, we establish a baseline for what mudaraba ought to entail under Islamic law. Second, the study examines how modern legal systems (both in muslim-majority and secular contexts) have recognized, adapted, or regulated the mudaraba arrangement. This involves a comparative review of regulatory frameworks – including the Malaysian Islamic Banking laws, the regulatory practices in GCC countries, the United Kingdom's approach to Islamic banking, and recent developments in Uzbekistan. Third, the research analyzes the operational and supervisory challenges encountered when implementing mudaraba in contemporary banking: for example, ensuring Shariah compliance while protecting investors, reconciling profit-sharing with prudential requirements (like capital adequacy and deposit insurance), and managing cross-jurisdictional differences in interpretation. Finally, the article aims to offer forward-looking insights and recommendations. By incorporating the perspectives of renowned Islamic finance scholars (such as Mufti Taqi Usmani, Shaykh Wahbah al-Zuhayli, and others) and drawing on comparative findings, the conclusion suggests how regulatory regimes might be reformed to bolster the viability of mudaraba without compromising its islamic legal integrity.

To achieve the above objectives, this research adopts a combined doctrinal, normative-regulatory, and comparative legal methodology. The doctrinal analysis involves a close reading of classical islamic legal sources on partnerships and trust-based contracts, with attention to the positions of the four sunni madhabs. We rely on translated excerpts and authoritative interpretations from classical jurists – for example, the Hanafi jurist al-Kasani, the Maliki jurist Ibn Rushd, the Shafi'i jurist al-Mawardi, and the Hanbali jurist Ibn Qudamah – as well as modern scholarly commentaries that summarize these views. The

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study is confined to sunni jurisprudence, as the four sunni schools historically reached consensus on the validity and core principles of mudaraba; references to non-sunni perspectives are excluded by design, in line with the focus on mainstream sunni doctrine.

Building on this foundation, a normative and regulatory analysis is conducted by examining contemporary legal instruments and standards that govern mudaraba in practice. These include national statutes (such as Malaysia's Islamic Financial Services Act 2013 and relevant civil code provisions), regulatory guidelines (for instance, Bank Negara Malaysia's policy on Investment Accounts, and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Shariah standards on mudaraba), as well as international standards (notably the Islamic Financial Services Board (IFSB) principles on risk management and capital adequacy for profit-sharing investment accounts). We also incorporate fatwas and rulings of modern Shariah supervisory bodies – for example, a recent fatwa from the Jordanian General Iftaa Department – to illustrate how contemporary islamic jurists reconcile classical rules with modern financial practices.

Comparative legal analysis is employed to highlight differences and similarities across jurisdictions in the implementation of mudaraba. The study strategically focuses on a set of jurisdictions that offer instructive contrasts: Malaysia, a leader in islamic finance with a sophisticated dual banking regulatory framework; the GCC countries (with particular reference to examples like Bahrain and the UAE) where islamic banking operates alongside conventional banking under various regulatory models; the United Kingdom, a secular common-law jurisdiction that has actively accommodated Islamic finance transactions; and Uzbekistan, a transition economy that is in the process of introducing Islamic banking law. This range allows us to see how legal and cultural contexts influence the regulatory handling of mudaraba – from full integration and bespoke legislation (Malaysia) to minimal legislative adaptation (UK) to nascent legal infrastructure (Uzbekistan).

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Methodology

The research began with a doctrinal study of classical islamic jurisprudence on mudaraba. Primary Islamic legal sources (Qur'an and Sunnah) implicitly sanction profit-sharing partnerships – for instance, historical reports note that the Prophet Muhammad (peace be upon him) engaged in profit-sharing trade with Khadijah's capital prior to his prophethood. Building on such origins, medieval jurists of all four sunni madhhabs elaborated the rules of mudaraba in detail under the law of partnerships. We surveyed major juristic works: for the Hanafi school, texts like Bada'i al-Sana'i by al-Kasani and the Majallah al-Ahkam al-Adliyyah (the 19th-century Ottoman codification of Hanafi commercial law); for the Maliki school, sources such as al-Mudawwana and Ibn Rushd's Bidayat al-Mujtahid; for the Shafi'i school, Imam al-Mawardi's treatise al-Hawi and al-Mughni by Ibn Qudamah (which, though Hanbali, often records Shafi'i views); and for the Hanbali school, Ibn Qudamah's al-Mughni and other compilations. We also consulted modern secondary expositions that compile these juristic positions – for example, Wahbah al-Zuhayli's Al-Fiqh al-Islami wa Adillatuhu (which compares rulings across madhhabs) and Nyazee's translation/commentary on Islamic law of business organizations. This doctrinal research elucidated the essential elements of a valid mudaraba: the contracting parties and their roles, the capital (types and conditions), the profit-sharing arrangement, the absence of any guarantee on capital, and the fiduciary duties of the manager. It also highlighted points of juristic consensus (ijma') and limited areas of divergence. Notably, we found a unanimous agreement among classical scholars on the permissibility and basic framework of mudaraba – as reflected in statements of consensus by authorities like Ibn al-Mundhir and Ibn Qudamah. Any variations among the schools tended to relate to secondary details (for instance, whether non-monetary assets can form the capital, or the extent to which the rabb al-mal can impose operational restrictions) rather than the fundamental concept.

In parallel, the study reviewed contemporary legal documents and standards governing Islamic banking. Key sources included national legislation (such as Malaysia's Islamic Financial Services Act 2013 and related guidelines, which explicitly address mudaraba-based accounts), regulatory standards by bodies

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like AAOIFI (e.g. Shariah Standard No. 13 on mudaraba) and IFSB (e.g. Guiding Principles on Capital Adequacy and Risk Management for institutions offering Islamic financial services), as well as official fatwas or circulars in different jurisdictions. For example, we analyzed the Central Bank of Bahrain's Rulebook for Islamic Banks for provisions on unrestricted investment accounts, and the UK's Financial Conduct Authority (FCA) rules and guidance relevant to Islamic deposits. We also examined recent developments in jurisdictions new to Islamic finance, most pertinently Uzbekistan – studying the draft law on Islamic banking (2025) and associated amendments to the civil code and tax code. Additionally, we included relevant international case law or disputes that shed light on mudaraba's enforceability – such as the 2017 Dana Gas sukuk litigation in the English High Court, which involved a mudaraba-based sukuk (investment trust certificates) and raised the issue of shariah compliance versus contractual obligations. While not a central focus, such cases inform our understanding of how secular courts perceive Islamic contracts [17].

By mapping both doctrinal principles and modern rules, we conducted a comparative analysis across jurisdictions. We selected Malaysia, GCC countries (including examples like the UAE and Bahrain), the United Kingdom, and Uzbekistan as primary comparators. These choices provide diversity in legal systems (common law vs. civil law), stages of Islamic finance development (mature vs. nascent markets), and regulatory philosophies (proactive integration of Shariah vs. neutral frameworks). For each, we gathered data on how Mudaraba is used and regulated: e.g., the prevalence of Mudaraba contracts in banking products, how profit-sharing investment accounts are treated (on or off balance sheet, insured or not), what governance structures (Shariah boards, etc.) oversee them, and any statutory definitions. Sources for this included central bank reports, academic studies, and in-country legal analyses. For instance, for Malaysia we used publications from Bank Negara Malaysia and the International Shariah Research Academy (ISRA) that discuss the implementation of investment accounts under IFSA 2013; for the GCC, we drew on IMF reports and scholarly articles about profit-sharing investment accounts and "displaced commercial risk"; for the UK, law review articles and practitioner guides (e.g. Lexology Q&As) on how Islamic banks adapt contracts

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within UK regulatory requirements; and for Uzbekistan, news reports and official statements about the new islamic banking bill [9].

Throughout the research, an effort was made to integrate the insights of prominent Islamic finance scholars. Figures like Mufti Muhammad Taqi Usmani, Justice Muhammad Imran Ashraf Usmani, Dr. Wahbah al-Zuhayli, and Dr. Muhammad al-Bashir al-Amine have penned influential works on islamic banking contracts. Their interpretations often bridge classical fiqh with modern finance and have informed standards in the industry. For example, Mufti Taqi Usmani's writings on Mudaraba provided clarity on the permissibility of certain modern structures and the importance of avoiding guaranteed returns [1, p. 35] Wahbah al-Zuhayli's scholarly compilations confirmed the classical consensus and described mudaraba in accessible terms (notably calling it a form of "silent partnership" [10, p. 193]. We use such insights not as unquestioned authorities, but as learned opinions that support our analysis or highlight debates (for instance, the discussion by contemporary Shariah boards on whether banks may smooth profits for mudaraba depositors, and under what conditions).

By combining these methods – classical doctrinal research, modern legal analysis, and cross-jurisdictional comparison – the study maintains both historical depth and practical relevance. The methodology allows us to trace a clear line from the theory of mudaraba in islamic law to its application in today's financial systems, identifying where the practice diverges from principle and why. This robust approach undergirds the findings reported in the next sections.

Results

In classical islamic law, mudaraba is unequivocally recognized as a lawful and established contract for profit-sharing partnerships. Its legal nature is essentially that of a partnership with an investor and a working partner, but it is distinguished from other partnerships by the asymmetry of contributions – one party contributes capital only, and the other contributes labor/skill only [10, p. 194]. This arrangement was widely practiced in Arabia even before Islam (as a convenient means for caravan trade where financiers employed traders), and Islamic jurists affirm that Islam ratified this practice under ethical guidelines. As Ibn Rushd (a 12th-century Maliki jurist) observed, "there is no disagreement among muslims regarding the permissibility of mudaraba, and it was something practiced in the pre-Islamic era that Islam approved". Classical scholars across all Sunni schools thus held mudaraba to be mubah (permissible) and in fact encouraged it as a form of partnership that embodies cooperation and risk-sharing instead of usury [2, p. 183].

The unanimity of the jurists on the validity of mudaraba is well-documented. Ibn al-Mundhir (d. 930 CE) and others related an early ijma‘ that the Prophet's Companions engaged in mudaraba and no scholar objected. Hanbali scholar Ibn Qudamah records that "the scholars have agreed on the permissibility of mudaraba". Al-Kasani, a prominent Hanafi jurist, further noted the continuous common practice of mudaraba: "People have been engaging in this practice since the time of the Messenger of Allah (peace be upon him) until today in all regions, with no objection from anyone, and the consensus of every era is a proof". This pervasive acceptance means the contract's core framework is largely uniform in classical law, with only minor differences in conditions among the schools [3, p. 97]..

Mudaraba is classically defined in almost identical terms by jurists of each school. In a typical definition (often quoted by modern scholars like Mufti Taqi Usmani), "Mudarabah is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise". The partner who provides the capital is known as rabb al-mal (owner of the wealth), and the partner who manages the venture is called al-mudarib (the manager). Importantly, the mudarib does not invest any of his own funds in a pure Mudaraba; his contribution is expertise and effort. Because of this, classical jurists sometimes dub the rabb al-mal a "sleeping partner" or silent partner, and the mudarib an active partner – hence the term "silent partnership" used by some modern writers. The metaphor of "traveling in the land" is embedded in the term's Arabic root (from *darb fil-ard*), reflecting that the mudarib often literally traveled to trade with the provided capital [10, p. 193].

The crux of mudaraba is the profit-sharing ratio agreed in advance. Classical law strictly requires that profits be distributed as percentages (fractions) of the actual profit earned by the venture, not as a fixed amount or guaranteed return [4]. For example, the contract may stipulate that the rabb al-mal gets 60% of any profit

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and the mudarib 40%. But one party cannot say "I get at least $1,000 no matter what" – any such guarantee of a fixed profit (or of principal) invalidates the contract by effectively imputing riba (usury or a predetermined gain) into the partnership. The Jordanian Civil Code, reflecting Islamic doctrine, states that any stipulation securing the capital for the investor (or a fixed profit) is void. Profit must be purely contingent on the venture's success and shared according to the agreed ratio. Furthermore, the profit ratio must be agreed *ab initio* (at the contract's inception); uncertainty or later negotiation on profit shares would render the contract void for gharar (excessive uncertainty) [4].

In the event of a loss, classical jurists uniformly hold that the capital provider bears any financial loss, whereas the mudarib loses the time and effort he invested [4]. This asymmetry is based on the notion that the mudarib, having not contributed capital, cannot lose money – his "loss" is the opportunity cost and labor expended. The rabb al-mal, meanwhile, absorbs monetary losses as an implicit trade-off for having sole ownership of the venture's assets. The mudarib is not liable for loss of capital except if the loss is due to his misconduct, negligence, or breach of the agreed conditions [4]. In such cases of proven fault, the jurists impose liability on the mudarib (analogous to a trustee who must compensate for breach of trust). This rule underscores the fiduciary nature of the mudarib's role: he is an ameen (trustee) in possession of the investor's money and must act with due care. Absent wrongdoing, however, even if the business fails entirely, the mudarib is not personally responsible to repay the capital – a principle that differentiates Mudaraba from a loan. As a Hanifi maxim in the Majallah put it, "profit is by agreement, but loss is by proportion of capital" – since only the investor put up capital, only he bears capital loss.

The classical fuqaha also discussed what qualifies as valid capital in a Mudaraba. Generally, capital must be a specified amount of money (gold/silver currency in classical terms) or fungible goods evaluated by mutual consent. Most schools (including Hanafis and Malikis) required the capital to be cash or monetarily appraisable liquid assets, to avoid disputes and ensure the profit can be measured against a clear principal sum. Malik ibn Anas reportedly forbade Mudaraba with non-monetary assets (merchandise) as capital, insisting on money as capital [19]. Later Maliki jurists allowed some flexibility if the goods are evaluated, but the overarching concern was to prevent ambiguity in capital value. Another condition is that the capital must be delivered to the mudarib (thus creating a trust). Debts cannot serve as mudaraba capital – one cannot say "instead of paying me what you owe, use it as mudaraba capital," because that lacks actual delivery and could mask a loan repayment with profit. This is reflected in modern fatwas: the Jordanian fatwa department, for instance, reiterated that the capital cannot be represented by a debt owed to the investor [4].

By default, a mudaraba is unrestricted (mudarabah mutlaqah) – the mudarib has latitude to trade with the capital in any manner he deems profitable, per customary business practice. The rationale is that since the mudarib is chosen for his expertise, he should not be micromanaged in executing the trade. However, the investor may impose certain restrictions at the time of contract, resulting in a restricted mudaraba (mudarabah muqayyadah) [12]. For example, the rabb al-mal might stipulate that the funds be used only for a particular industry or region, or not be invested in certain high-risk ventures. Such conditions are acceptable to most jurists so long as they do not thwart the very purpose of the partnership. If the mudarib violates a legitimate condition (e.g. he trades in a banned sector or without permission undertakes a voyage that was forbidden), and loss occurs, he can be held liable for that loss due to breach of contract. Classical texts recount that some companions, acting as rabb al-mal, would stipulate conditions like "do not sail across the sea, do not trade in livestock, etc., otherwise you are liable" – implying that conditions to limit risk were known and enforceable. Absent any explicit restriction, the mudarib may conduct any business in the normal course of commerce, and even hire agents or workers as needed. A contentious sub-issue discussed by jurists was "mudarib yudharib" – can the mudarib himself appoint another mudarib (i.e. pass the money to a third party in a second-tier Mudaraba)? The views differed: generally it was deemed allowable with the investor's permission. Notably, Wahbah al-Zuhayli summarizes that all four Sunni schools agreed if the first mudarib does so without permission and the capital is lost, he must guarantee the loss. This again highlights the emphasis on trust: unauthorized delegation that leads to loss is viewed as misconduct making the first mudarib liable.

Modern American Journal of Business, Economics, and Entrepreneurship
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Classical law permits either party to terminate the Mudaraba at will (since it is based on mutual agency and trust), unless the contract was for a specified term. Upon termination or expiry of the Mudaraba, any remaining assets are liquidated: the investor recoups his capital first, and any surplus is profit to be split per the ratio. If losses have occurred that exceed any interim profits, the net loss reduces the capital repaid to the investor.The mudarib's share of profit materializes only after the capital is repaid (jurists often phrase that profits are not recognized (distributed) until the capital is intact). This ensures that the mudarib does not take profit when the business as a whole made no net gain. Classical jurists even allowed that if the Mudaraba yielded profit in some operations and loss in others, the losses could be offset against profits before any sharing occurs– essentially, profit is calculated on the aggregate outcome [4].
From the above, it is clear the jurists conceived mudaraba as a joint enterprise rooted in mutual trust and equitable sharing of outcomes. The mudarib's legal status is multifaceted: he is at once an agent (wakeel) of the investor for purposes of trade, a trustee (ameen) for holding the assets, and a partner (shareek) in the profits that result [12]. However, he is not a partner in the sense of equity contribution – only in the sense of profit entitlement. Because of these roles, if the mudarib transgresses or is proven negligent, he departs from the role of trustee and effectively becomes a guarantor (liable party) for losses caused by his fault. The classical books frequently mention that mudarib is not liable for loss except if he acted contrary to the conditions or was negligent, underscoring the moral and legal responsibility placed on the manager.
Notably, the classical model of mudaraba is flexible in practice. It can be one-tier (a single rabb al-mal financing a single mudarib) or multi-tier. Jurists allowed multiple investors pooling funds in one mudaraba with one mudarib, as well as one investor engaging multiple mudaribs jointly. In the latter scenario, the multiple mudaribs effectively become partners among themselves (each contributing labor) while dealing with the investor's pool of capital. These structures anticipated modern fund management concepts. The only caveat was that profit distribution must be clearly articulated – e.g. if two mudaribs work with one capital, their share of the profit between themselves should be pre-agreed (such as splitting the mudarib's portion 50/50 between them).

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In summary, classical Sunni jurisprudence endows mudaraba with a distinct legal identity as a commenda-type partnership based on agency and trust. It is neither a loan (for the capital is risked, not guaranteed) nor a full partnership in capital (since only one side contributes capital), but a hybrid that had no exact parallel in pre-modern Roman or civil law – though interestingly, medieval European merchants developed the commenda and societas arrangements quite similar to mudaraba, likely influenced by Islamic commercial practice. The legal nature of mudaraba is thus that of a nominate contract in Islamic law, well-defined by juristic consensus and detailed conditions, emphasizing profit-sharing instead of interest, and the alignment of investor-manager incentives under the moral boundaries of Shariah.

Transposing the mudaraba into modern legal systems presents both conceptual convergence and practical tension. In essence, the traditional mudaraba corresponds to what contemporary jurists might call a fiduciary investment partnership. Many jurists and legislators in the islamically influenced jurisdictions have viewed it as analogous to a silent partnership or limited partnership in Western terminology – where one partner's liability is limited to invested capital and that partner does not participate in management. Indeed, historical research suggests the European medieval commenda (from which modern limited partnerships evolved) was adapted from the Islamic Mudaraba/Qirad. Modern civil laws in several Muslim-majority countries have incorporated Mudaraba concepts, either explicitly or implicitly, into their statutes.

For instance, Jordan's Civil Code (which is based largely on Islamic jurisprudence for commercial transactions) has provisions effectively codifying Mudaraba rules: it affirms that the capital owner bears losses and any agreement to guarantee capital is void, mirroring the classical position [4]. Similarly, the Egyptian Civil Code and those influenced by it (Syrian, Kuwaiti, etc.) allow for partnership contracts where one party contributes capital and the other expertise, even if not explicitly named "Mudaraba." Pakistan took a unique legislative step by enacting a Mudaraba Companies and Mudaraba (Floatation) Ordinance 1980, creating a regulatory framework for Mudaraba as a form of business organization (used to establish Islamic investment companies or mutual funds

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known as "Modarabas"). This illustrates direct recognition of the concept in statutory law, though Pakistan's law treats Modaraba more as a company/trust structure for multiple investors.

In secular common-law environments, there is no predefined notion of "Mudaraba," but its substance can be understood in terms of existing legal concepts. In the UK, for example, a Mudaraba arrangement would be seen as a kind of investment partnership or trust. Legal commentators note that under English law, nothing prevents two parties from entering a contract where one provides funds to another to trade and share profits – that would typically be construed either as a partnership (if ongoing business together) or an investment management contract. The United Kingdom has accommodated Islamic financial contracts by interpreting them through the lens of English contract and trust law. English partnership law could recognize a Mudaraba as an ordinary partnership except that usually the investor would not want to be treated as a general partner with joint liability. Instead, U.K. Islamic banks often structure profit-sharing investment accounts in a way that the bank is effectively a trustee or agent for the depositor's funds rather than a partner in the legal sense, to avoid partnership law complications. Still, conceptually, UK authorities have acknowledged that a Mudaraba is akin to a partnership "wherein the investor (rabb al-mal) contributes the capital and the recipient (mudarib) provides expertise to earn profit shared per agreement".

The more significant modern perspective is how banking regulators treat Mudaraba contracts, especially when used for deposit-like products. In conventional banking, a "deposit" implies a debt obligation of the bank to repay the customer. Mudaraba, by contrast, implies no guaranteed repayment – the bank (mudarib) is not a debtor to the client, but rather a fund manager who will return whatever remains of the investment plus share of profit. This fundamental difference has led to different regulatory approaches:

In countries with dedicated Islamic banking regulation (e.g., Malaysia, Sudan, Iran), laws often explicitly define investment accounts under profit-sharing contracts distinct from guaranteed deposits. For example, Malaysia's IFSA 2013 legally differentiates an "Islamic deposit" (which must guarantee repayment of principal and is used for Wadiah or Qard contracts) from an "investment account" which utilizes Mudaraba or Wakala and carries no principal guarantee. By this statute, any account using Mudaraba is *not* a deposit and thus not covered by deposit insurance or payout guarantees – a direct enshrinement of the classical doctrine into modern law. This ensures the legal nature of a Mudaraba fund in Malaysia is truly that of a trust-like investment, aligning with Shariah that losses are borne by investors. Bank Negara Malaysia further issued detailed rules for the conduct of such investment accounts (e.g., requiring clear risk disclosures to investors) [5].

In the GCC countries, where many banks operate as "Islamic windows" or alongside conventional banks, the treatment of Mudaraba-based accounts has historically been less codified. Many Gulf jurisdictions did not initially have separate legal definitions; Islamic banks simply took deposits on a Mudaraba basis as a matter of contract, often disclosing that "profits are not guaranteed." However, in practice, a strong depositor expectation of capital protection emerged (with banks often forgoing some of their profit share to smooth returns – a practice known as displaced commercial risk, discussed later). Some countries like Bahrain adjusted their regulatory framework by treating unrestricted investment accounts as a separate category in regulatory reports (with AAOIFI accounting standards distinguishing them from owners' equity). In Kuwait and the UAE, recent laws have moved toward formalizing Islamic finance: e.g., the UAE's 2018 Islamic banking regulations and central Shariah board oversight. Wahbah al-Zuhayli had noted that modern legislation must clarify the status of such accounts, but even without uniform laws, the basic civil law principle (often derived from Shariah for personal law) is that an investor in a profit-sharing venture bears losses. For instance, the UAE's civil code is based on Islamic law and would likely uphold that notion if called upon [20].

In secular financial hubs like the United Kingdom, accommodating Mudaraba required creative regulatory interpretation. The challenge was that under UK law (specifically the Financial Services and Markets Act 2000 and the Regulated Activities Order), a "deposit" is defined as an amount paid to a bank on terms under which it will be repaid in full on demand or at an agreed time. A pure Mudaraba deposit, where the bank is not obliged to repay in case of loss, would fail this test and thus not be considered a deposit – meaning an Islamic bank

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taking money on that basis might fall outside the normal depositor protection regime, which is undesirable for consumer confidence. The UK regulators' solution was effectively to tweak the contract: Islamic banks in Britain operate under an understanding that the customer is in practice entitled to repayment of principal (thus meeting the legal definition of a deposit for regulation), but the customer may waive or relinquish profit (or even the claim to principal) on religious grounds if they wish. In other words, the contract is drafted to satisfy regulatory requirements (no risk of losing principal from a regulatory standpoint), while giving devout investors the option to decline the guarantee. This has been described in a Lexology commentary as ensuring "depositors under a Mudarabah would be entitled to full repayment of the amount deposited… As this could be construed as a guarantee… the rabb al-mal would, however, have the right to opt out of the deposit protection on religious grounds". Additionally, UK Islamic banks often use alternative contracts (like Wakala with a target return) for deposit products to achieve a similar economic effect with principal protection, precisely because a true Mudaraba raises these legal issues. Nonetheless, legally the notion of an investment partnership is recognized – English law will enforce the terms of a Mudaraba agreement as a matter of contract, as long as there is no violation of public policy. For instance, in the Dana Gas case (pertaining to a sukuk structured as a Mudaraba), the English High Court had no issue dealing with it under English law, apart from interpreting the contract; the court notably refused to entertain an argument that "non-Shariah-compliance" voided the deal, holding the contractual commitments (governed by English law) supreme. This underscores that in a secular court, the Mudaraba's Shariah-based nature does not carry legal force unless written into the contract obligations [7].

In countries like Uzbekistan, which historically operated entirely on conventional banking principles, new legislation is being crafted to integrate Islamic contracts like Mudaraba. As of late 2025, Uzbekistan's parliament has advanced an Islamic banking law that explicitly introduces the concept of Mudaraba (along with other contracts) into the legal system. The draft law defines terms such as "Mudaraba" in the Uzbek context and seeks to amend the Civil Code to accommodate partnership-based financing. It also lifts certain

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
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existing restrictions – for example, current Uzbek banking law forbids banks from trading or owning equity stakes, which is incompatible with Mudaraba (where a bank as mudarib might need to buy and sell goods or take equity positions). The new law proposes allowing banks to participate in trade and companies' capital specifically to facilitate contracts like Mudaraba and Musharaka [9]. Thus, Uzbekistan is effectively adjusting its civil and banking law to make room for the Mudaraba concept, treating it as a legitimate mode of financing. This is a strong example of modern law recognizing Mudaraba's unique nature: rather than forcing Mudaraba into existing categories (loan, deposit, etc.), the law is creating a tailored category for it, complete with a special tax regime and regulatory oversight measures (such as a proposed Council on Islamic Finance to oversee Shariah compliance).

In summary, from a modern civil law perspective, Mudaraba is generally seen as a form of partnership or investment management arrangement. Jurisdictions influenced by Islamic jurisprudence have either embedded its principles in their codes (e.g. the loss-bearing rule in Jordan's code, Pakistan's Modaraba companies framework) or are enacting specific legislation (as in Uzbekistan). In purely secular systems, while the term "Mudaraba" may not appear in statutes, the concept is intelligible via analogous constructs (trust, partnership, fund). The critical adjustments happen in the regulatory domain – especially banking regulation – to reconcile the Mudaraba with prudential requirements and customer protection norms [8].

One can observe a spectrum: at one end, Malaysia legally separates Mudaraba-based investment accounts from deposits, thereby fully preserving the contract's risk-sharing nature in law. In the middle, many GCC banks treat Mudaraba deposits in practice as if they were deposits, sometimes even providing de facto guarantees, with regulators gradually moving to formalize standards for profit-sharing accounts. At the other end, the UK overlays a de jure guarantee on Mudaraba deposits to fit them into the conventional banking paradigm (with an opt-out for the religiously inclined). These approaches reflect different priorities: Malaysia prioritizes Shariah authenticity and transparency of risk, while the UK prioritizes consumer protection and regulatory parity, and the GCC historically

Modern American Journal of Business, Economics, and Entrepreneurship
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Volume 01, Issue 09, December, 2025
Website: usajournals.org

prioritized rapid growth of Islamic banking often by analogizing it to conventional banking (though this is changing).

Therefore, the legal nature of Mudaraba in modern settings straddles two characters: (a) a fiduciary partnership contract between investor and entrepreneur (this is its Shariah character that many laws acknowledge), and (b) in banking, a type of investment product that might need its own regulatory classification. But fundamentally, wherever true Mudaraba is maintained, the notion of no guaranteed return and shared risk is its defining legal feature. Modern Sunni jurists consistently warn that if a so-called Mudaraba includes features that guarantee the investor's capital or yield, it ceases to be a valid Mudaraba and becomes something more like a loan with interest in disguise [4]. This view influences regulators and courts in many jurisdictions when deciding how to enforce or allow Mudaraba contracts. For instance, the Jordanian fatwa quoted earlier explicitly rules that stipulating a capital guarantee "invalidates the mudarabah contract", and interestingly notes that if a Mudaraba is invalidated thus, the arrangement reverts to a form of relationship where the worker gets a fixed wage (ujrat al-mithl) and the investor bears losses – essentially, the law will not honor a profit guarantee clause but may enforce compensation on a different basis [4].

Overall, the treatment of Mudaraba in contemporary law demonstrates a dynamic interplay between classical Islamic legal principles and modern regulatory objectives. The next section will delve into how these legal conceptualizations play out in actual Islamic banking operations, what regulatory frameworks exist to supervise Mudaraba-based products, and how different jurisdictions cope with the challenges inherent in this profit-and-loss sharing model.

Discussion

In practice, modern Islamic banks employ Mudaraba contracts in two main domains: (a) on the liabilities side, to mobilize funds from depositors/investors (often termed investment accounts or profit-sharing deposits), and (b) on the assets side, to finance entrepreneurs or projects (often termed Mudaraba financing). The former – Mudaraba-based deposit accounts – is far more

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

common than the latter. It is somewhat ironic that while classical theory might have envisaged Mudaraba as a vehicle for investors to fund traders (like a financier funding a trade caravan managed by a mudarib), today it is predominantly used inversely: the public (as investors) deposit money with an Islamic bank which acts as the mudarib, investing those funds in various Shariah-compliant ventures.

In this arrangement, an Islamic bank offers accounts (general investment accounts, term investment accounts, sometimes also called unrestricted or restricted Mudaraba accounts) where the customer agrees that the bank will invest the funds and share any profits according to a declared ratio. The bank typically pools all such Mudaraba deposits into an investment pool. Profits earned by the bank from financing and investments are then split between the bank and the investors (depositors) per the agreed ratio (for example, 50/50 or 70/30 in favor of the customer, etc., often after the bank first deducts itself a performance incentive or management fee if disclosed). If the bank incurs losses on those investments, the depositor is supposed to take a loss in the sense of diminution of their funds' value, while the bank would simply not get a profit share (and lose its effort). In theory, this aligns exactly with the classical model – the depositors are rabb al-mal, the bank is mudarib.

However, in practice, a full loss to depositors has been exceedingly rare. Islamic banks are acutely aware that customers generally expect their deposits to be safe. As a result, a phenomenon known as Displaced Commercial Risk (DCR) became prevalent: banks voluntarily forgo part of their own profit share, or draw on reserves, to ensure depositors get a competitive (or at least non-negative) return even in low-profit years [13, p. 16]. Many regulators tacitly allowed or encouraged this via mechanisms like Profit Equalization Reserves and Investment Risk Reserves (per IFSB guidelines), which are funds set aside from profits in good times to smooth out returns in bad times. The net effect is that Islamic banks have treated Mudaraba deposits almost like conventional deposits, trying to avoid losses or large profit fluctuations for depositors. While this practice addresses consumer expectations and confidence (and prevents withdrawals), it also dilutes the pure Mudaraba risk-sharing principle, effectively shifting some risk back to shareholders. The IMF has noted this as a

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

key *stability issue*: Islamic banks often do not actually let investment account holders bear losses, meaning the banks absorb those losses, making their risk profile closer to conventional banks [13, p. 16]. This has regulatory implications: if investment accounts are loss-absorbing in theory but guaranteed in practice, the bank's capital adequacy and depositor protection frameworks need to account for that discrepancy.

Different jurisdictions have taken different approaches to this issue. Malaysia stands out for formally moving Mudaraba accounts off the "deposit" ledger. Under IFSA 2013, as noted, Mudaraba accounts are categorized as *Investment Accounts* that are explicitly not principal-guaranteed. Malaysian banks had to either convert those accounts into true deposits (using a different contract like Wadiah) or re-classify them as investments with proper risk disclosures. Consequently, since 2015, Malaysian Islamic banks offer Islamic deposits (fully guaranteed accounts often based on Wadiah or commodity Murabaha) separately from Investment Accounts (based on Mudaraba or Wakalah bi istithmar) which are not guaranteed and not covered by deposit insurance. Customers choose which they want: a safer account or a potentially higher-return but risk-bearing investment. This clarity has been lauded as aligning practice with principle – profit-sharing investments now truly mean what they say in Malaysia. Early evidence indicates a majority of retail customers preferred to shift to guaranteed deposit accounts (the banks often switched retail savings to Wadiah), while more sophisticated investors might use investment accounts for better returns. The Malaysian regulator provided a framework for banks to manage these investment pools and even set up a platform (Investment Account Platform – IAP) to channel investment account funds into ventures like SMEs [12, p. 11].

In the GCC, formal separation is less common (although Bahrain's framework comes close, requiring clear disclosure to account holders that their funds are profit-sharing and at risk). Typically, Islamic banks in GCC countries report profit-sharing investment accounts on their balance sheet as a special category (neither pure liability nor equity) and often include a note that depositors' principal is not guaranteed. Yet, deposit insurance schemes in some countries have started to include Islamic deposits. For example, Bahrain includes Islamic account holders in its banking deposit protection system up to a limit, and Qatar

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

explicitly covers Islamic deposits. This raises Shariah concerns because deposit insurance (especially if funded by interest-bearing instruments or if it guarantees even in case of genuine loss) can conflict with the Mudaraba idea. Some reconcile it by treating deposit insurance as a third-party guarantee or tabarru (donation) fund. Indeed, Jordan's Islamic deposit insurance fund, for instance, does not cover restricted investment accounts (where the client picks the project) but does cover unrestricted ones to a degree, reasoning that small depositors are "unsophisticated". This paternalistic approach is practical, but again it means in those jurisdictions the regulatory function of Mudaraba accounts is drifting toward treating them as protected deposits for consumer protection reasons. The trade-off is a potential Shariah compliance issue – scholars generally permit government-mandated deposit insurance for Islamic banks as a form of public interest, but purists argue it should ideally be a profit-sharing investment with no guarantee.

On the financing side, banks using Mudaraba act as rabb al-mal, providing capital to a customer (entrepreneur) who acts as mudarib. This is comparatively rare because it exposes the bank's capital to higher risk (the bank lacks collateral in a pure Mudaraba and cannot demand repayment in case of loss absent misconduct). It is most commonly seen in investment fund structures or specific project finance. For example, an Islamic bank might finance a small business by giving funds under a Mudaraba agreement instead of a loan; the entrepreneur will use the money, and the bank will share the actual profits (like an equity stake) rather than take interest. If the business fails without negligence, the bank could lose the funds. Due to these risks and the administrative difficulty of monitoring the entrepreneur's performance, few banks extensively use Mudaraba financing. When they do, they often put safeguards: e.g., requiring the mudarib to keep detailed accounts, sometimes pairing the Mudaraba with a guarantee from a third party (controversial but sometimes done), or preferring a Musharaka (joint venture) instead so the bank has an equity share and some control.

From a regulatory perspective, asset-side Mudaraba is treated similar to an equity exposure. In Basel/IFSB capital standards, a Mudaraba financing might attract a higher risk-weight (to reflect potential loss) and requires banks to have

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

robust risk management – as there is a danger of moral hazard (the mudarib taking excessive risks since it's not his money). Some regulators may limit the proportion of such profit-sharing modes on a bank's balance sheet due to their riskiness. Indeed, one reason Islamic banks hold mostly debt-like assets is capital adequacy norms: a Murabaha (which is debt) carries less capital charge than a Mudaraba (which is an equity investment with potentially full loss exposure). In practice, regulators in many countries indirectly discouraged Mudaraba and Musharaka financing by not giving any favorable treatment, and by requiring heavy provisioning or capital if they were used. The upshot is Islamic banks themselves shy away due to both internal incentives and external regulatory pressures.

Nonetheless, there are niches where Mudaraba thrives. Investment funds and Sukuk: Some Shariah-compliant investment funds are structured as Mudaraba pooled investments. Also, certain Sukuk (Islamic bond-like instruments) use Mudaraba as their underlying contract. In a Mudaraba Sukuk, investors purchase participation certificates that represent a share of the Mudaraba business managed by the issuer as mudarib. Profits from the business are distributed as periodic returns, and at maturity the Mudaraba is wound up and capital returned (in theory, could be less than full, but usually there are mechanisms to stabilize returns – as seen in the Dana Gas case, where a guarantee-like structure was included, leading to legal dispute). These capital market uses of Mudaraba bring their own regulatory questions about investor protection and disclosure, but they lie more in securities regulation than banking supervision.

In summary, operationally, Mudaraba in contemporary banking is primarily a tool for investment account structuring and occasionally for equity-like financing. Its presence in products is directly tied to how amenable the regulatory environment is and how comfortable institutions are with the risk/reward profile.

The regulatory function of Mudaraba – that is, how regulators oversee and facilitate (or constrain) the use of Mudaraba by Islamic financial institutions – varies widely. We discuss several major challenges and how different jurisdictions address them:

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

The foremost challenge is ensuring that profit-sharing investment account holders understand and accept the risk of loss, while also maintaining systemic trust. Regulators must balance Shariah compliance (no guarantees) with the public policy goal of protecting small investors. As noted, Malaysia tackled this by segregating the accounts: those who want protection go to guaranteed deposits, those who want higher returns opt in to investment accounts with disclosed risks. This model required significant regulatory planning, industry adjustment, and even amendments to deposit insurance law (Malaysia's deposit insurer PIDM no longer covers investment accounts). The result is a two-tier banking model in Islamic banks themselves.

In contrast, countries like Bahrain or the UAE historically did not enforce such segregation, and implicitly allowed Islamic banks to treat investment accounts with extra care. The concept of a fiduciary duty is crucial: Many jurisdictions impose (either through regulation or expectation) a fiduciary responsibility on Islamic banks towards their investment account holders. For example, Bank Negara Malaysia's guidelines require Islamic banks to have a sound investment account governance framework, including how they manage and allocate assets to those accounts, handle reserves, and disclose information, effectively holding them to a higher standard of care in lieu of a guarantee [13, p. 17].

Deposit insurance for Mudaraba accounts remains a contentious point. Some scholars allowed a takaful (Islamic insurance) scheme to compensate investment account holders in cases of loss due to misconduct or perhaps limited losses, but agree that guaranteeing against normal loss goes against Mudaraba. Regulators have sometimes innovated by making deposit insurance for Islamic accounts operate on a tabarru (mutual guarantee) basis – e.g., Sudan's system or Pakistan's proposed system – to satisfy Shariah conditions (participants mutually insure each other's deposits). However, these are technical fixes; fundamentally, the regulator's conundrum is that if they do not guarantee, they fear a competitive disadvantage or bank runs, and if they do guarantee, they negate the risk-sharing principle. The IMF and IFSB have recommended clarity and possibly a separate insurance fund for profit-sharing accounts, or simply enhanced disclosure as in Malaysia's approach [11].

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

As mentioned, Islamic banks often smooth returns. From a regulatory angle, this practice needs guidelines because it can obscure the true risk profile of the bank and mislead investors. IFSB introduced the concept of Alpha (α) – the proportion of risk effectively transferred from profit-sharing investment account holders to the bank's own shareholders. If a bank regularly shields account holders from losses, then those accounts are not absorbing risk and are more like liabilities; hence regulators might require the bank to hold capital against those assets as if they were its own. Some jurisdictions (e.g., Bahrain, Malaysia) have adopted formulas to incorporate displaced risk in capital adequacy calculations, meaning banks that protect depositors must hold more capital, incentivizing them to actually let investors bear risk or explicitly categorize funds differently [13, p. 17]. This is a complex area, but essentially regulators must monitor if banks are properly managing the expectations – ensuring that if a bank says "your funds are at risk", they do not routinely bail them out with shareholder funds, or if they do, that they're robust enough to afford it.

Another vital aspect is how regulators ensure that Mudaraba contracts are truly Shariah-compliant and fairly implemented. Islamic banks typically have internal Shariah boards that approve products like Mudaraba accounts. Some countries like Malaysia and recently the UAE have a Central Shariah Board that issues overarching rulings. These bodies can standardize the Mudaraba practices (for example, disallow certain profit smoothing tricks, or insist on clear contract terms). Malaysia's Shariah Advisory Council resolutions are legally binding on Islamic banks and even on courts; the SAC has, for example, ruled on how conceptually dividends from Mudaraba should be treated or whether certain reserve practices are permissible. In the GCC, AAOIFI standards serve as a guideline – AAOIFI's Shariah Standard on Mudaraba provides detailed rules consistent with classical fiqh (e.g., no fixed return, no liability on mudarib absent negligence) [4]. Bahrain and other states that mandate AAOIFI compliance ensure banks follow those standards in their Mudaraba offerings. Meanwhile, the UK leaves Shariah compliance entirely to the institutions and their boards; the regulator does not opine on Shariah, only on whether consumers are treated fairly and given appropriate info. This means in the UK, a bank could possibly call something Mudaraba and still guarantee it (with an opt-out) because the secular law doesn't forbid it – as long as transparency is there. For example, the FCA has required that Islamic banks clearly inform deposit clients that they have a right to forgo interest (profit) for religious reasons if they choose. The UK approach is thus one of functional regulation – treat Islamic products in terms of their economic function (deposit, investment, etc.), regulate accordingly, and leave Shariah aspects to contract.

When we compare across regions:

Malaysia: Regulatory function of Mudaraba is highly developed. The central bank plays an active role to ensure Mudaraba contracts operate in a safe and Shariah-compliant manner. The legal infrastructure (IFSA 2013) provides certainty – any profit-sharing investment is not guaranteed, deposit insurance is not applicable, and in the event of bank liquidation, those investors rank differently from depositors. The supervisory challenge in Malaysia was to educate consumers and manage the transition; indeed, a large educational campaign accompanied the reclassification of accounts. Over time, Malaysia has also innovated by letting banks offer varying tiers of investment accounts (general vs specific investments, with varying risk profiles) and requiring them to publish performance reports. This increases market discipline – investment account holders can compare returns and risk across banks, somewhat akin to mutual fund investors [6].

GCC Countries: There is diversity. Bahrain probably has the most advanced oversight (with AAOIFI standards enforced and separate reporting for unrestricted and restricted investment accounts). The UAE only recently (2018 regulations) started requiring Islamic windows and banks to follow certain centralized rules and for example, forbids them from promising to cover losses of investment account holders except through a Shariah-compliant mechanism (like a third-party guarantee from shareholders' funds as a donation, which some scholars allow). In contrast, Saudi Arabia historically did not have a separate Islamic banking law at all; banks operate as conventional from a regulatory perspective, and Shariah compliance is internal – so a Saudi bank's profit-sharing accounts are essentially treated by SAMA like any other deposit in terms of prudential treatment, but the bank internally ensures the profit allocation is per Mudaraba. This can lead to a disconnect: contractually the client bears risk,

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

but regulatorily the bank might cushion them. The Kuwait finance law explicitly mentions Mudaraba as one of Islamic banking modes, but in legal disputes Kuwaiti courts have sometimes struggled with profit-loss arrangements (tending to protect investors). Qatar and UAE have introduced central Shariah supervision recently, which may harmonize practices (e.g., the UAE's Higher Sharia Authority could issue a ruling standardizing Mudaraba account treatment across all UAE Islamic banks) [20].

United Kingdom: The UK's regulatory engagement with Mudaraba has been pragmatic and secular. Key developments included adjustments to tax laws so that profit shares in Mudaraba are not doubly taxed or treated disadvantageously. For instance, early on, UK tax law was amended (Finance Act 2005 and subsequent) to ensure returns on Islamic financing (like a deposit's profit share or sukuk returns) get similar tax treatment to interest. The prudential regulators (PRA/FCA) in the UK generally require Islamic banks to meet the same capital/liquidity standards; there is no special leeway for Mudaraba assets or liabilities. However, they have issued guidance acknowledging Islamic contracts. The case of deposit definition we covered: making sure if a bank calls something a deposit, it does meet RAO conditions, hence the quasi-guarantee solution. An interesting scenario occurred with the Bank of England and FSCS: initially, it was ambiguous if profit-sharing investment accounts were covered by deposit insurance. The consensus now is that UK's FSCS will cover Islamic bank accounts up to £85,000 just like conventional ones, because the banks structure them to be repayable (even if the customer can waive). There was some critique that this effectively secularizes the product – one scholar wrote that using FSCS for Islamic accounts "is problematic… providing ex-post guarantee undermines the PLS nature". Some have called for a change whereby Islamic banks could offer fully risk-bearing accounts outside FSCS, but that has not gained traction due to consumer protection concerns.

Uzbekistan: As an emerging example, Uzbekistan's new framework is being designed to anticipate these issues. The draft law suggests that investment deposits (Mudaraba/Musharaka) will be introduced deliberately, and presumably not guaranteed by banks. It also amends laws that would otherwise impede Mudaraba (e.g., allowing banks to own equity, as mentioned).

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

Supervisory structures like a Council for Islamic finance under the central bank will likely issue guidelines on how these contracts should be managed and accounted for. Uzbekistan is learning from Malaysia, Turkey, UAE – officials explicitly said the law draws on those experiences [9]. This means Uzbekistan might implement, from the start, things like separating Islamic deposits from investment accounts, requiring strong Shariah governance, and perhaps using takaful-based deposit insurance for Islamic accounts. The significance of Uzbekistan is also political – by formally allowing Mudaraba, the law integrates an Islamic contract into a post-Soviet civil law system that had no concept of it. The success of this integration will depend on detailed regulations and the banking sector's capacity to handle profit-loss sharing.

A universal regulatory challenge is ensuring that the complexity of Mudaraba does not obscure the customer's understanding. Regulators increasingly mandate clear disclosure of the nature of the contract: that returns are variable, past performance is not a guarantee, capital could be lost, how the profit is calculated, what fees (if any) the bank takes, etc. In some jurisdictions, marketing of Mudaraba accounts must avoid using terms like "deposit" or "saving" without clarification. There is also an emphasis on distinguishing restricted vs unrestricted Mudaraba (if the customer's funds go into a specific project or a general pool). The modern investor or depositor needs information akin to what mutual fund investors get in the conventional world. For example, Bank Negara's guidelines require banks to provide an Product Disclosure Sheet to investment account holders with scenarios of returns, etc. Such regulatory requirements are crucial to align with conduct-of-business principles and consumer protection.

If a Mudaraba contract spans jurisdictions (say a UK investor investing with a GCC bank, or a sukuk issued in one country under another's law), there can be legal uncertainties. Typically, contracts specify governing law (often English law for international deals). This was illustrated by the Dana Gas sukuk incident: the issuer (UAE-based) tried to use UAE law (and Shariah notions) to invalidate the contract, while investors took the issue to English court since English law governed parts of the deal. The English court refused to entertain Shariah-based arguments, enforcing the contract as written (which included payment

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

obligations). This case underlines that outside a purely Islamic law court, Mudaraba contracts will be interpreted through secular contract principles. A regulatory takeaway is that issuers of cross-border Mudaraba instruments should not assume that a general reference to Shariah will be upheld if it conflicts with the explicit terms and governing law. Therefore, careful legal drafting and perhaps choosing an appropriate arbitral forum can help. It also suggests that as Islamic finance globalizes, there might be a need for more harmonized standards or at least mutual recognition: for instance, a clear statement in a contract that "the mudarib is not obliged to guarantee capital" should be respected in any court as a contractual allocation of risk.

The discussion would be incomplete without noting how influential bodies and scholars shape regulation. AAOIFI in particular provides Shariah standards that many regulators incorporate (Bahrain mandates them, others use them as guidelines). AAOIFI's Standard on Mudaraba echoes classical fiqh and also provides modern operational guidance – for example, it permits the Mudarib to commingle his own funds with the Mudaraba (making it a kind of hybrid Musharaka) only if a separate contract of Musharaka is in place; it forbids the mudarib from offering a loan to the Mudaraba to cover losses (except in case of negligence which he must cover) because that would indirectly guarantee profits [4]. These standards and the pronouncements of renowned scholars (like Taqi Usmani, who chaired AAOIFI's Shariah Board for many years) effectively become part of the regulatory ethos. National Shariah boards (where present) also issue guidelines – e.g., in Sudan, the Higher Shariah Supervisory Board famously banned the use of certain risk mitigation that would compromise Mudaraba's integrity, insisting on profit-sharing as per fiqh [14].

Leading contemporary scholars often discuss innovations to overcome Mudaraba's challenges. For instance, Mufti Taqi Usmani has proposed models to make Mudaraba more practicable, such as a two-tier Mudaraba combined with agency mechanisms – where depositors invest with a bank (first tier Mudaraba), and the bank invests in entrepreneurs (second tier), but uses tools like reserves or incentive alignment to reduce moral hazard [13, p. 18]. Some propose using technology (Fintech) to better monitor Mudaraba projects, thus reducing information asymmetry[13, p. 12]. Muhammad al-Bashir al-Amine, a scholar in

Islamic finance, has discussed risk management tools like profit equalization reserves or even Shariah-compliant hedging that could be employed to protect Mudaraba investments without violating Shariah (for example, using takaful to insure certain risks). Regulators increasingly pay attention to such scholarly input, especially in jurisdictions trying to deepen Islamic finance. The dialogue between scholars and regulators is institutionalized in places like Malaysia (through annual conferences, the presence of scholars on central bank committees, etc.).

Bringing the threads together, we highlight comparative insights:

Malaysia offers a model of integrated legal infrastructure for Mudaraba. By anchoring the concept in statute and delineating it from conventional products, Malaysia achieves high legal certainty and Shariah compliance. The trade-off is complexity: banks must manage two types of accounts and educate consumers. But Malaysia's approach shows that with regulatory will, Mudaraba can be offered transparently without implicit guarantees. It also shows that regulators can actively encourage profit-and-loss sharing – e.g., Bank Negara and the government provided incentives for Investment Account Platforms and for banks to channel funds to needed sectors via Mudaraba. As a result, while initially banks were cautious, in recent years Malaysian banks have launched various Mudaraba-based investment accounts (for example, Bank Islam's Special Investment Account) targeting higher returns for customers over a fixed term by investing in asset portfolios. These resemble a kind of Islamic fixed-income mutual fund in economic effect.

GCC countries illustrate a more market-driven, gradual approach. They started with minimal changes to conventional banking law, letting Islamic banks innovate within contract law. Over time, experiences (and occasional missteps) led to incremental regulation. A significant insight is how market expectations can override contract form – Gulf depositors often assumed their money was safe in Islamic banks just like conventional, leading banks to act accordingly. Only in the last decade have GCC regulators begun aligning the practice with form, under pressure from both Shariah scholars and international standard-setters. For example, after the global financial crisis of 2008, there was increased scrutiny on how Islamic banks manage displaced commercial risk, prompting

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

regulators in Bahrain, UAE, etc., to firm up guidelines on reserves and disclosures. The GCC also shows diversity: some countries like Oman (a late adopter, establishing Islamic banking in 2013) benefited from being a "late starter" by writing comprehensive Islamic Banking Regulatory Frameworks from scratch, explicitly covering Mudaraba deposits and requiring, for instance, that any smoothing of returns be done via pre-agreed mechanisms and not by altering the profit share ex post. Oman thus effectively imported best practices from others.

United Kingdom demonstrates that legal flexibility can accommodate Islamic contracts, but also that certain concessions to the conventional system will be made. The UK's handling of Mudaraba deposits (making them fit the deposit definition) is a case in point. A positive insight is that such accommodation allowed the establishment of fully-fledged Islamic banks under UK law without needing a parallel legal system. UK regulators maintained a level playing field – Islamic banks must follow the same prudential rules – but also tweaked rules like taxation of returns and regulatory definitions to remove unfair hurdles for Islamic contracts. The UK experience suggests that in non-Muslim jurisdictions, the main regulatory function regarding Mudaraba is ensuring consumer protection and financial stability are not compromised. As long as those are fine, regulators are neutral to the underlying contract form. The UK also serves as a forum for legal precedence: the resolution of disputes like Dana Gas under English law provides some reassurance that even complex Mudaraba-based structures can be enforced in secular courts, albeit purely on contractual terms.

Uzbekistan (and by extension other newcomers like Kazakhstan or Russia, which have shown interest in Islamic finance) highlights the importance of legal reform to enable Islamic banking. Uzbekistan is effectively modifying multiple laws (tax, civil, banking) to clear obstacles and explicitly allow Mudaraba and others [9]. A key insight here is that without such legal provisions, a Mudaraba might not fit into an existing framework – e.g., if a civil code does not recognize non-guaranteed investment contracts, or if tax law would treat profit shares as irregular income. By preemptively legislating, Uzbekistan aims to avoid legal uncertainty. It also underscores the role of comparative learning: Uzbek lawmakers studied Malaysia, GCC, the UK, and are trying to pick the best

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

elements (like setting up central Shariah governance and adjusting prudential rules). The real test will be implementation: training regulators, bankers, and judges in understanding Mudaraba. Given Uzbekistan's majority Muslim population and interest in ethical finance, the success of this law could pave the way for Central Asia to adopt more Islamic finance. However, one must be mindful of cultural context – depositors in these countries might be even less aware of profit-loss sharing concepts, so intensive literacy campaigns are likely needed so that, for instance, a farmer investing in an Islamic bank knows that if the bank says it's a Mudaraba deposit, it's not like the old Soviet-style guaranteed savings.

Each jurisdiction's approach to Mudaraba reflects a balance between Shariah authenticity, market forces, and regulatory priorities. A general observation is that jurisdictions with strong Islamic banking sectors (Malaysia, GCC) are increasingly converging on international standards (IFSB, AAOIFI) which themselves attempt to codify the classical fiqh in modern form. Meanwhile, Western regulators show that with careful adjustments, Islamic contracts can operate within a conventional regulatory framework, but they may sacrifice some of their pure form in the process (e.g., via guarantees or accounting treatment). The involvement of authoritative Sunni jurists remains crucial across all these regions – either directly (in predominantly Muslim countries, scholars sit on advisory boards to central banks) or indirectly (Western regulators rely on Islamic banks' Shariah boards which in turn rely on those scholars' fatwas). Therefore, one cannot separate the legal/regulatory function of Mudaraba from its Shariah governance function: the two must work hand in hand. The classical juristic principles guide the ideals, and regulators craft the mechanisms to uphold or approximate those ideals in the real world of banking.

From the foregoing analysis, several persistent challenges in supervising Mudaraba-based operations become evident, along with emerging solutions:

These issues are endemic to Mudaraba – the mudarib has more information and may not always act in the rabb al-mal's best interest (since losses are not his to bear). Classical jurists mitigated this by imposing liability for misconduct and by allowing the rabb al-mal to stipulate conditions. Modern regulators add tools like requiring financial reporting and audits for Mudaraba funds. For instance,

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

banks may have to provide periodic investment reports to account holders, and independent Shariah audits can verify that profit calculations were correct and no hidden perquisites were taken by the mudarib. Fintech solutions, like blockchain-based tracking of investments or crowd-investing platforms, are being explored to increase transparency for investment account holders. Some startups and Islamic banks are creating online dashboards where investors see exactly where their money is invested (sector-wise if not name-wise) and the performance. This can reduce information asymmetry.

If a dispute arises (say an investor alleges the bank was negligent with his Mudaraba funds), do courts and regulators have the expertise to adjudicate? In Malaysia, there's a court referral mechanism to the central Shariah council for interpretive questions. In other countries, there might need to be capacity building for judges on Islamic finance. The onus is also on writing contracts that clearly spell out duties and standards of care. Many banks include clauses defining what constitutes negligence or misconduct by the mudarib (the bank or entrepreneur) in measurable terms, to avoid ambiguity.

As Islamic finance grows, an issue is when, for example, a GCC bank offers Mudaraba accounts to a UK customer through an online platform – which law governs and who protects the customer? Regulators through bodies like the IFSB are encouraging harmonization and perhaps reciprocal recognition of frameworks. For now, such cross-border retail offerings are limited, but pan-GCC or ASEAN passporting might bring it up. Possibly, an international Islamic deposit insurance scheme could even be contemplated for cross-border protection, though that is far off [15].

Supervisors sometimes face proposals from banks to "enhance" Mudaraba with features to make it more palatable – e.g., a bank wanting to guarantee a minimum profit via a charity from shareholders, or using a hybrid of Mudaraba and a swap to stabilize returns. How should regulators react? If too lenient, Mudaraba could be turned into a disguised interest product; if too strict, Islamic banks might be at disadvantage. The general trend has been to allow certain Shariah-compliant enhancements: for instance, AAOIFI permits a third-party (not the mudarib or rabb al-mal) to give a voluntary guarantee of capital. In practice, many Islamic banks' shareholders or parent companies provide letters of comfort that they would cover losses in extreme cases – not legally binding but morally reassuring. Regulators often turn a blind eye or implicitly endorse this, considering it part of systemic stability. However, this remains a gray area and a bit of a legal fiction to keep everyone comfortable. The scholarly community is divided; some approve third-party guarantees (seeing it as benevolence), others worry it undermines PLS [14].

Recent economic stresses test how Mudaraba works. During the COVID-19 pandemic, some Islamic banks had lower profits or even losses. How many actually passed losses to investment account holders? Early indications: most tried to keep paying some profit by drawing on reserves or reducing the bank's share to zero. Regulators, focused on maintaining confidence, likely supported that approach. But it begs the question: if losses were sustained, would depositors accept erosion of their balances? Law aside, the practical reality is many small depositors would not. Thus the challenge remains psychological and communicational: building an investor base that truly understands risk sharing. Islamic finance education and marketing need to emphasize this to gradually cultivate acceptance. That is a socio-regulatory challenge beyond just writing rules.

As long as different countries treat Mudaraba differently, banks could potentially arbitrage. For example, a bank in Country A might have to hold more capital for Mudaraba accounts than a bank in Country B, so it might prefer to operate out of B or route transactions there. International standards like IFSB aim to reduce such gaps by recommending uniform treatment. The push for global "Islamic Basel" standards is ongoing [15].

In facing these challenges, a consistent theme emerges: clear governance, transparency, and alignment of interests. Classical jurists dealt with them through conditions and moral governance; modern regulators add formal governance structures and quantitative measures. The views of classical jurists, interestingly, often prefigured modern solutions: for instance, the prohibition of gharar (uncertainty) in profit splits is akin to insisting on transparent profit calculation; the requirement of amanah (trustworthiness) is echoed by today's fiduciary duties. We see that authoritative Sunni jurists, both old and new, remain a reference point. To give a concrete example, consider the recent fatwa from

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

Jordan's iftaa department we cited: it not only restated classical conditions but also referenced modern implementation like civil code articles[4].Such fatwas, when issued by respected bodies, can guide judges and regulators in multiple countries due to the commonality of Islamic principles. They effectively bridge the gap between the old jurisprudence and contemporary application, reinforcing confidence that adhering to Shariah in letter and spirit is still feasible in today's financial world.

Conclusion

The Mudaraba contract, as this article has explored, sits at the heart of Islamic banking's identity as a risk-sharing, partnership-based system, yet it also epitomizes the tensions between classical ideals and modern realities. From our comprehensive examination of its legal nature and regulatory function, several conclusions and recommendations can be drawn.

First, the legal nature of Mudaraba in Islamic jurisprudence is exceptionally clear-cut and unanimously endorsed by Sunni authorities: it is a *profit-and-loss sharing partnership* where monetary capital from one party and managerial effort from another are combined, profits shared per agreement, and losses borne by capital. This definition, affirmed by classical jurists like Ibn Rushd, al-Kasani, and others, establishes an unambiguous Shariah benchmark. The modern incarnations of Mudaraba in various legal systems have, at their best, sought to respect these fundamentals – as seen in statutes and regulations that prohibit guaranteeing the investment or fixing returns [4]. However, in practice, especially within banking, the pure form has been frequently diluted to meet consumer expectations and regulatory safeguards. Our comparative analysis showed that while jurisdictions like Malaysia have managed to implement Mudaraba in banking in a way that stays truer to its original spirit (through non-guaranteed investment accounts), others like the UK have effectively reshaped the contract (imposing guarantees) to align it with conventional frameworks. The GCC countries historically hovered in between, with implicit guarantees and smoothing, though they are now inching closer to the principle as standards tighten.

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

Second, the regulatory function of Mudaraba – meaning the role it plays and how it is managed within financial regulation – is evolving and critical. Mudaraba contracts in banking serve the important function of mobilizing risk capital and potentially financing ventures on an equity-like basis, something that conventional banks do not traditionally do. This function aligns with broader economic benefits espoused by Islamic finance proponents, such as profit-loss sharing fostering more responsible finance and tying financial returns to real economic performance. However, regulators face the challenge of integrating this function without undermining financial stability. We found that effective regulatory strategies include: clear contractual segregation (as per IFSA 2013 in Malaysia); enhancing governance and disclosure (e.g., requiring banks to publish profit distribution reports, which increases transparency for investment account holders); and developing Shariah-compliant safety nets (such as profit equalization reserves or takaful-based insurance for deposits) to manage extreme outcomes. The involvement of central Shariah boards and standards has been beneficial in many places to ensure that any innovation still falls within accepted Shariah parameters – ensuring, for instance, that reserves or third-party guarantees do not become a stealth way of assuring profit, but remain contingency measures [6].

This article offered a rare integrated perspective, bridging classical jurisprudence and contemporary regulatory analysis. One original contribution is the detailed mapping of how each comparative jurisdiction treats Mudaraba, highlighting not just differences in law but the underlying philosophy. For example, we highlighted that the UK's approach essentially transforms Mudaraba into a trust-like consumer product, whereas Malaysia's approach nurtures Mudaraba as an investment product distinct from deposits – reflecting two different philosophies of consumer protection vs. authentic risk-sharing. Another contribution is bringing in the voices of classical jurists in direct conversation with modern laws. By citing primary fiqh texts and fatwa [4]. alongside banking regulations, we demonstrated where modern practice deviates from or adheres to the letter and spirit of Islamic law. This kind of juxtaposition can inform policymakers in Islamic finance: it shows, for instance, that certain debated issues (like whether a bank may ever cover losses of investors) were in

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

fact contemplated by jurists (in the guise of the mudarib's liability for misconduct or the permissibility of charitable guarantees by third parties) [4].Understanding these analogues can inspire regulators to design solutions that are both effective and religiously palatable.

Recommendations for Regulatory Reform:

1. Strengthening Transparency and Contracts: Regulators should mandate a high standard of disclosure for Mudaraba-based accounts/products. A standardized "Mudaraba investor disclosure" could be adopted internationally, detailing rights and risks in simple language (much like key facts statements for mutual funds). This empowers customers and also forces banks to stick to genuine profit-sharing arrangements. Part of this transparency should include how profits are calculated and allocated, whether any reserve or smoothing practice is used, and under what conditions the customer might lose capital. Clarity in contracts – explicitly stating that the investor's funds are not guaranteed and obtaining informed consent to that – is necessary not only for Shariah validity but also to protect banks legally if a loss occurs.

2. Formalizing Profit Smoothing Mechanisms: If regulators wish to allow banks to cushion investment account returns to a degree, this should be codified rather than left informal. For example, regulators can permit the creation of Profit Equalization Reserves (PER) as a percentage of profits in high-return years, which can be utilized in low-return years, within clear limits. By formalizing this, regulators can also require that if PER is exhausted, losses must be passed through – thereby preventing a bank from endlessly protecting investors at the expense of its solvency. This would institutionalize a balance between risk-sharing and stability.

3. Adaptive Deposit Insurance Schemes: Jurisdictions should consider developing Islamic deposit insurance windows or funds that respect the nature of Mudaraba. As suggested by some experts, a possible model is a two-tier insurance: the principal of Mudaraba accounts is not guaranteed by the state in normal times, but a takaful-based fund is available to compensate in cases of proven fraud or extreme loss beyond certain thresholds. Alternatively, regulators could explore requiring banks to include a clause allowing depositors to voluntarily opt out of insurance to preserve Shariah compliance, similar to the

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

UK model but structured as an explicit choice at account opening. The key is to reconcile public policy of protecting small investors with the contract's ethos. Perhaps insurance coverage could be limited to a percentage of the balance or triggered only in liquidation events, thereby not interfering with day-to-day profit outcomes.

4. Enhanced Shariah Governance: We recommend that countries establish or empower central Shariah supervisory authorities to issue guidance on Mudaraba practices. These bodies can ensure consistency (e.g., all banks should treat certain fees or contingencies uniformly) and can update interpretations as new issues arise. For instance, with fintech enabling more direct investment, Shariah bodies should clarify how online P2P Mudaraba platforms can operate (perhaps akin to crowdinvesting rules). The presence of central Shariah oversight, as in Malaysia and now in the UAE and some others, provides confidence and a clear point of reference for dispute resolution.

5. Encouraging True Mudaraba Financing: From a developmental perspective, regulators and governments might provide incentives for asset-side Mudaraba and Musharaka financing. Since banks are currently disincentivized (due to high capital charges and risk), policymakers could consider measures like: offering profit-sharing investment account funds to be channeled into specified economic sectors under co-funding arrangements, or providing partial guarantees or subsidies for certain Mudaraba projects that have social value (e.g., agriculture or SMEs). Another idea is tax incentives – e.g., profits paid out to investment account holders could be tax-exempt or tax-reduced to encourage public participation in these risk-sharing schemes, making them more attractive relative to fixed deposits. This echoes how some countries gave tax breaks for sukuk to level the playing field; similarly, making the outcome of Mudaraba attractive could draw more participation and scale up its use.

6. Education and Cultural Shift: Regulators in both Muslim-majority and minority contexts should not underestimate the educational component. We propose that central banks engage in or mandate financial literacy programs specifically around Islamic financial products. As part of licensing Islamic banks or windows, regulators could require these institutions to conduct community seminars or publish educational materials about how Mudaraba works, including

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

case studies of profit and loss scenarios. Over time, this could cultivate a base of customers who truly embrace the concept (much like equity investors in stocks understand their shares can go up or down). The aim would be to slowly shift the culture from one of guaranteed deposits to one of informed investment, at least for a segment of the market.

7. Cross-border Collaboration: Given that Islamic banking often operates across borders (GCC banks in multiple countries, etc.), regulators should collaborate through forums like the IFSB to harmonize key aspects of Mudaraba regulation. This includes agreeing on definitions (what constitutes a restricted vs unrestricted investment account), sharing data on how investment accounts perform, and coordinating in crisis management (if an Islamic bank with Mudaraba accounts in several countries were to fail, how would losses be handled across jurisdictions). Such collaboration could prevent arbitrage and also present a united front that strengthens the credibility of Islamic finance globally.

The ongoing integration of Mudaraba into modern finance is not just a technical process but a test of Islamic finance's value proposition. If regulators and institutions manage to implement Mudaraba in a way that is faithful to its principles, the system will offer a genuine alternative to debt-driven finance – one that ties rewards to real economic outcomes and shares risk more broadly. This resonates with maqasid al-Shariah (the higher objectives of Shariah), such as justice and equitable distribution of wealth. However, if Mudaraba is only nominally used and in reality transformed into a fixed return product through back doors, then Islamic banking would drift towards the very paradigm it sought to change.

Encouragingly, the trends documented – from Malaysia's reform to Uzbekistan's new law – show an increasing maturity and confidence in handling Mudaraba. Jurisdictions are learning from past challenges (the moral hazard issues, legal uncertainties) and devising frameworks that can make Mudaraba viable. The views of contemporary scholars like Taqi Usmani, who once lamented the decline of profit-sharing modes, are being heeded through renewed efforts to polish and practice these modes rather than abandon them.

Modern American Journal of Business, Economics, and Entrepreneurship
ISSN (E): 3067-7203
Volume 01, Issue 09, December, 2025
Website: usajournals.org

In conclusion, the Mudaraba contract's journey from classical Islamic texts to 21st-century banking halls illustrates the dynamic adaptability of Islamic law. Its legal nature remains that of a trust-based partnership, and its regulatory function, when properly harnessed, can deepen the ethical and resilience features of financial systems. To fully realize this, stakeholders – regulators, banks, and customers alike – must continue to recalibrate mindsets and frameworks, moving step by step toward a financial practice that truly embodies shared risk and reward. The regulatory reforms and proposals outlined above seek to advance that mission. Ultimately, the success of Mudaraba in modern Islamic banking will be measured not only in profitability or market share, but in the integrity and stability it brings to the financial sector, and in the confidence it instills that finance can indeed be conducted as a partnership of trust rather than a zero-sum game of lender versus borrower.

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Modern American Journal of Business, Economics, and Entrepreneurship
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Volume 01, Issue 09, December, 2025
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Modern American Journal of Business, Economics, and Entrepreneurship
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Volume 01, Issue 09, December, 2025
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