Chapter 30
Cost–Efficiency Analysis of Mudarabah Companies

Hadia Sohail
University of Management and Technology, Pakistan

Noman Arshed
https://orcid.org/0000-0002-8940-5391
University of Management and Technology, Pakistan

ABSTRACT
The economic system recognizes the role of the financial system as an important cog in its machinery. Several theoretical and empirical studies have evidenced its contributing role to the economy. Within the overall financial system, the Islamic financial system ensures the increase in productivity of capital as well as in the synchronization between the incomes of the rich and the poor. Mudarabah companies stay at the forefront of the Islamic financial system. Their knowledge-intensive approach helps the allocation of resources in long-term ventures and, because of their participation-based setup, they can theoretically cause a trickle-down effect via their redistribution process from the borrower to the lender. Practically, though, this requires the financial institutes such as Mudarabah to be cost-efficient. This chapter explores specifically how efficient Mudarabah companies of Pakistan are in terms of cost minimization, and investigates whether different dimensions of intellectual capital can improve cost efficiency.

INTRODUCTION

Mudarabah Companies

Financial intermediation is regarded as the hidden component in the circular flow of the economy, whereby it tries to involve and utilize the excess resources available at household and firm level, and invest them in ventures with the highest possible returns, consequently increasing the productivity of capital. All this effort is done to earn share as an intermediary (interest rate spread, in the case of conventional financing). In any economy, a mature and inclusive financial system is vital for the enhancing of business
productivity, resource utilization, and mobility. Finance houses are also important, as they are specialized in investments and they support the banking systems, which are specialized in gathering deposits. The specialization of treasurer of finance house in placements of financing may also help in minimizing the issues related to asymmetric information and moral hazard (Fried & Hisrich, 1994; Yousfi, 2012).

Mudarabah companies, as the Islamic counterpart of conventional finance houses, is a mode of finance which Holy Prophet (May peace be upon him) and his companions (Radeyallāhu ‘Anhu (RA)) practiced as finance providers (rab ul mal, in Arabic) or finance acquirers (Mudarib) (Kahf & Khan, 1992; Mughal, 2012; Siddiqi, 1985). Though the concept of Mudarabah mode of finance was introduced by Islam a long time ago, it was commercialized around the 1980s, and, after a slow initial growth, is now gradually gaining attention (Rehman, Chaudhary, Rehman, & Zahid, 2011). In Pakistan, Mudarabah companies operate as a Mudarabah management company under the Companies Ordinance 1984 by Securities and Exchange Commission (SECP) (Shaikh, 2017). Financial houses such as Mudarabah companies access the idle liquidity mainly from banking institutions and firms to place a pool of funds into Shari’ah-based Islamic investments and earn in terms of compensation to their efforts as investors (Mudarib). This engagement of resources, especially in the long run, has a potential for boosting economic growth as other financial intermediaries do (Afza & Asghar, 2012, 2014), because they are literally increasing the average productivity of the engaged capital in the economy, while supporting the production process and increasing savers’ incomes. Subsequently, Mudarabah companies acquire and typically allocate resources based on the risk-sharing participatory mode, rather than of fixed predetermined interest rate. First, this setup shares the borrower’s risk, making Mudarabah liable to ask for Shari’ah-compliant compensation. Secondly, the advantage is that this setup transfers variable returns to the fund providers. Since, these returns are based on the financing performance of venture, which leads to the synchronization between borrowers’ and lenders’ earning.

Financial institutes are becoming very important in current competitive and unpredicted economy like Pakistan. Financial institutes basically use idle funds in the most productive products of the economy. This is the actual reason for which every country should have an efficient and stable financial institution setup which can help the economy to grow (Asghar & Afza, 2013). Better financial institutions lead to financial inclusion of the masses, which reduces the cost of capital and provision of credit and insurance facilities (Rahman, 2014). Historically, this financial system has played a decisive role in the industrialization of England (Hicks, 1969), although the financial system contains a broad range of financial institutes which include banking and nonbanking institutes as well. Being a part of the financial system, Mudarabah companies are also contributing to the development of Pakistan (Afza, & Asghar, 2014). Developing country such as Pakistan offers a quiet high opportunity for leasing and Mudarabah companies for growing businesses (Shoaib, 2017). Ul-Hassan and Usman (2013) suggested that there is a high chance of growth for Shari’ah-compliant products. In Pakistan, the Mudarabah companies are providing short-term and long-term finances, and contributing very much towards the development of Pakistan.

A very important sector which is overlooked in business is Islamic finance; it is also very important because for the Muslims it works according to Islamic religious beliefs. However, past research publications show that, during the crisis of 2008, the Middle East and Asian countries were not affected as much as North American and European countries (Raza, Jawaid, & Shafqat, 2013). Within this Islamic financial system, Mudarabah companies play an important role in allocating financing. They are different from their conventional counterparts in a way that the rules of a Mudarabah financing house are driven by Shari’ah. The Shari’ah foresees that a Mudarabah company must participate in sharing the risk which
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