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ORIGINAL ARTICLE

Challenges and solutions for *Mudarabah* financing: an exploratory study of Islamic banks in Palestine

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Abstract

Mudarabah, a profit-and-loss sharing partnership where one party provides capital and the other manages the business, is underutilized in Islamic banking despite its alignment with *Shariah* principles. This study explores the challenges limiting *Mudarabah* financing in Palestinian Islamic banks and proposes practical strategies to enhance its application. Using a qualitative approach, in-depth interviews with key bank executives were conducted to investigate internal, client-related, and regulatory barriers. The findings indicate that *Mudarabah's* limited use stems from internal constraints such as inadequate staff training and expertise in Islamic finance, and external issues including clients' lack of verified financial records and economic transparency, raising concerns of moral hazard. Structural challenges within *Mudarabah* contracts, such as limited bank oversight, monitoring difficulties, and the agency problem, further restrict adoption. To address these issues, the study recommends enhanced employee training, creation of comprehensive client databases, phased fund disbursement, and the adoption of blockchain technology to improve transparency and compliance. While the study focuses on the Palestinian context, the insights offer broader implications for Islamic finance in similar environments. This research contributes to the literature by identifying specific barriers to *Mudarabah* and offering actionable strategies to promote its effective use. Implementing these measures could help Islamic banks better fulfill their ethical mandates and support inclusive economic development.

Keywords Islamic banks · Mudarabah financing · Qualitative research · Developing countries

Introduction

The *Mudarabah* financing model represents a partnership where one party provides capital (*Rabbul-Maal*) and the other manages the business (*Mudarib*), embodying principles of profit-and-loss sharing (PLS), equity, and justice. Despite its theoretical appeal, *Mudarabah* remains underutilized in Islamic banking due to its high risk and lack of collateral, with many banks favoring *Murabahah*, *Ijarah*, and other asset-backed methods that offer greater security [1–3]. The information asymmetry inherent in *Mudarabah* further complicates bank liquidity, creating potential for moral hazard where the *Mudarib* might not act in the best interest of the *Rabbul-Maal* [2]. To manage these risks, Islamic banks often impose strict terms on *Mudarabah* agreements or restrict their use to specific sectors, reducing risk but limiting *Mudarabah's* broader economic impact, especially in underserved communities [4].

The impact of *Mudarabah* goes beyond a PLS-based alternative to conventional finance. Due to restrictions of traditional finance, the PLS-based contracts allow Muslim entrepreneurs to transform an idea into commercial venture [5]. There are two important byproducts of this process. *First*, there are no clients or customers in a *Mudarabah* financing. Customers become partners, indicating a sense of "engagement" in a social cause [6]. Second, the PLS-contract instrumentalizes community cohesiveness in times of financial uncertainty [7]. Hence, *Mudarabah* contracts

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are not mere indicators of social responsibility of the Islamic banks, these are symbols of religious, economic and cultural integration in an Islamic society. The profit-sharing rates offered by the PLS contracts are also found to dominate the conventional market rates in the short run [8]. Cultural, social, and community engagements are strongly found in Palestinian societies. Despite having a long history of conflict, Palestinians survived because cohesive community and partnership among the local [9].

In Palestine, three Islamic banks are operating. However, similar to the global evidence, *Mudarabah* financing is particularly rare in Palestine. Financial statements reveal that between 2016–2023, only about 1% of total funds at Arab Islamic Bank and Palestine Islamic Bank and none (0%) at Safa Bank have employed *Mudarabah*. These banks have preferred easily manageable sale-based models like *Murabahah* [10]. Even though these are not directly comparable because of the diversity and size of the Islamic financial markets, Indonesia Islamic Financial Development Report[1] shows that the proportion of *Mudarabah* is only 2.13% in 2023 (46% *Murabahah*). Recent report identifies that the same to be less than 1% in Malaysia's money market financing.[2] It was the same even twenty years ago for the entire banking system in Malaysia [11]. On a global scale, Islamic Financial Services Board[3] has reported for 2018 that the global proportion of *Mudarabah* asset is only about 1.3% of the total Islamic banking assets. Despite its important theoretical contribution, essentially, the important question remains: why is *Mudarabah* so underutilized in global Islamic banking? This study explores this question for Palestine.

A host of financial, operational, market, regulatory, and even, cultural factors are responsible for such a sluggish development of profit-and-loss sharing contracts [5]. For Palestine, part of the challenges lies in the regulatory environment. While banks operate under the Palestinian Monetary Authority (PMA) and their Shariah boards, current regulations insufficiently incentivize *Mudarabah* [12]. Favoring sale-based financing models, this framework reflects a trend in the broader Islamic banking landscape, where clearer guidelines could encourage *Mudarabah* use [2, 13]. When compared to a much deeper regulatory support for profit-and-loss sharing contracts, Malaysia's regulatory authority offers support using Investment Accounting Platform and Islamic Interbank Money Market [14]. These initiatives help reduce the liquidity shortage and governance related complexities in Malaysia.

Operationally, banks often view *Mudarabah* as high-risk instrument, given the potential for business failure and economic instability in regions like Palestine [9]. This uncertainty drives preference for *Murabahah*, which allows banks to secure returns via a fixed markup [1]. Globally, studies show similar reluctance to adopt *Mudarabah* on a large scale, citing agency problems, financial risks, and volatile returns [3, 15]. In *Mudarabah* arrangements, banks must place significant trust in the *Mudarib*; yet, the lack of transparent information flow often leads to adverse selection and moral hazard, limiting *Mudarabah's* effectiveness.

This research aims to explore the reasons behind the limited use of *Mudarabah* financing and to propose solutions for enhancing its application in Palestinian Islamic banks. Specifically, the study addresses two key questions: (1) What are the challenges associated with the use of *Mudarabah* financing in Palestinian Islamic banks? and (2) What strategies can be implemented to increase the utilization of *Mudarabah* contracts in these banks?

The study offers a qualitative contribution by investigating the perspectives of key financial practitioners in Palestinian Islamic banks, with a focus on the operational, regulatory, and risk-related challenges surrounding *Mudarabah* financing. Although centered on Palestine, the findings may provide valuable insights for Islamic banking systems in other regions facing similar constraints. By identifying and addressing these barriers, the study reveals the potential for *Mudarabah* to drive economic development through the integration of capital and labor.

The research is structured into six sections: the introduction, study background, methodology, challenges of *Mudarabah* financing in Palestinian Islamic banks, proposed solutions for expanding *Mudarabah* financing, and the conclusion.

Review of the past studies

Mudarabah contract

Mudarabah is a key financial arrangement in Islamic finance rooted in *Shariah* principles of profit-sharing. In this contract, one party (the capital provider, or *Rabbul-Maal*) supplies the funds, while the other (the entrepreneur, or *Mudarib*) manages the venture, with profits shared according to pre-agreed terms. The Quranic verse "and others travel through the land seeking of God's bounty" (Quran 73:20) is often cited as the basis for this model, highlighting the ethical nature of trade and cooperation for mutual benefit [16].

[1] Islamic financial development report (2023), available at https://www.ojk.go.id/en/berita-dan-kegiatan/info-terkini/Documents/Pages/Indonesian-Islamic-Financial-Development-Report-LPKSI-2023/

[2] Malaysia's money market financing – the proportion of Mudarabah financing, available at https://www.bnm.gov.my/documents/20124/54166/The-Malaysian-Islamic-Financial-Market-Report.pdf

[3] Islamic Financial Services Board (IFSB) 2018 financial stability report, available at www.ifsb.og.

Mudarabah contract establishes a partnership in which the investor accepts financial risk while the entrepreneur offers expertise and labor. Losses fall on the *Rabbul-Maal* unless caused by misconduct, negligence, or breach of contract by the *Mudarib* [1]. Profit distribution in *Mudarabah* follows the principle of "profit as a protection of capital", ensuring the bank recovers its initial investment before profit distribution [17].

Unlike *Murabahah* (cost-plus financing) and *Ijarah* (leasing), *Mudarabah* uniquely emphasizes risk-sharing, discouraging risk-free profit, or *Riba* (interest), in alignment with *Shariah* values [18]. The absence of guaranteed returns and reliance on mutual trust underscore *Mudarabah* as a reflection of Islamic economic justice. Similarity, PLS-based contract embodies equity, ethics, and balanced distribution of risks [19].

In contemporary Islamic banking, *Mudarabah* can be either restricted (where the investor limits how funds are managed) or unrestricted (allowing the entrepreneur more freedom) form of contract. The unrestricted form aligns more closely with Islamic ethical principles by permitting the entrepreneur discretion in business decisions [20]. However, due to concerns over agency issues and moral hazard, many banks impose restrictions to maintain oversight [3].

In banking practice, *Mudarabah* contracts are used in investment accounts, with banks acting as intermediaries or investors. As intermediaries, they pool funds from individual investors for *Shariah*-compliant projects, sharing profits with investors [4]. The *Mudarib* manages the investment, and losses are borne by the *Rabbul-Maal* unless the *Mudarib* breaches contract conditions [21]. This risk-sharing theoretically promotes prudence among entrepreneurs, though banks tend to prefer lower-risk models like *Murabahah* due to *Mudarabah's* inherent uncertainties [22].

Mudarabah contrasts with *Musharakah*, another profit-sharing model, where both parties contribute capital and share both profits and losses. In *Mudarabah*, only the capital provider bears financial loss, enabling the entrepreneur to focus on management without assuming financial risk [16].

The definitions of *Mudarabah* among Palestinian banks reflect these principles. Arab Islamic Bank describes *Mudarabah* as a partnership where the bank provides capital, with profits divided based on pre-agreed rates and losses borne by the bank unless caused by negligence or breach. Palestine Islamic Bank's definition aligns, viewing *Mudarabah* as a partnership where the bank supplies capital, and profits are shared at an agreed ratio. Losses due to default, negligence, or violation of conditions fall on the managing party, and profits or losses are recognized when reasonably estimated or declared. Similarly, Safa Bank's definition highlights an agreement in which one party supplies capital while the other provides expertise, with profits shared and losses borne by the capital provider except in cases of default or infringement. These definitions reflect the core principles and ethical spirit of Islamic finance.

Major challenges associated with *Mudarabah* contract

Islamic banks face significant challenges in implementing this financing model effectively due to operational issues, agency problems, and concerns around regulation and risk management. It is difficult for Islamic banks to potentially act as a "business partner" and compete against conventional banks with a very simplified financing model. Hence, there is a significant institutional dilemma that often results in operational complexities managing the *Mudarabah* contracts. Tarriko and Hakmaoui [23] have found these complexities being translated into confusion and lack of preference during crisis periods of COVID-19 among banks in Morocco. They have identified the need for quality human resources and the choice of quality clients (customers) for the *Mudarabah* contracts.

A critical issue in *Mudarabah* contracts is the agency problem, stemming from the separation of ownership and control [24]. In a typical arrangement, the *Rabbul-Maal* provides capital while the *Mudarib* manages the business, creating a principal-agent dynamic that often results in information asymmetry. This asymmetry enables the *Mudarib*, who has more insight into the business operations, to potentially act against the financier's best interests, leading to moral hazard and adverse selection [3]. Without effective oversight, inefficient resource allocation and eroded stakeholder trust are likely outcomes. To mitigate these risks, scholars suggest incorporating Islamic codes of conduct, including the religiosity of the clients, financial capabilities and entrepreneurial literacy of clients as well as banks, and the *Shura* (participative decision-making) process to enhance transparency [3, 24].

Another obstacle to *Mudarabah* is its high financial risk [14]. Although PLS-based contracts, such as *Mudarabah,* are designed to facilitate risk-sharing, Islamic banks often hesitate to fully embrace this principle, frequently requiring collateral from the entrepreneur, which contradicts the essence of *Mudarabah* [2, 25]. This conservative stance reflects a preference for profit-sharing without accepting potential losses, a fundamental element of true risk-sharing. The higher financial risks associated with *Mudarabah* compared to more secure, debt-based products like *Murabaha* further explain this reluctance [1]. Hassan-Bello [15] argues that banks' unwillingness to bear losses distorts the risk-sharing framework and undermines the trust of Profit-Sharing Investment Account Holders (PSIAHs), who expect banks to uphold Islamic principles. This imbalance between risk-sharing and profit-sharing significantly limits *Mudarabah's* effectiveness and diminishes its appeal as a genuine profit-and-loss sharing mechanism. Sugozu et al. [26] argued that due to the lower economies of scale which is common in pure PLS-based contracts, Islamic banks may face higher risk compared to the conventional banks. Yustiardhi et al. [14] suggested use of fintech to reduce costs related to monitoring. However, the explanation on the use of fintech was not given.

Additionally, earnings volatility presents a substantial challenge in *Mudarabah*. Research indicates that the high fluctuation in earnings associated with profit-and-loss sharing contracts, particularly *Mudarabah*, contributes to banks' preference for more predictable structures like *Murabaha*, which ensures stable returns [22]. Gök et al. [8] argued that PLS-based rates are less efficient compared to the conventional rates. This inherent uncertainty makes it difficult for banks to maintain stable income streams, which are crucial for financial stability.

Another critical obstacle is the lack of standardization and clear regulatory frameworks governing *Mudarabah* contracts. Islamic financial institutions often operate under varied interpretations of *Shariah* law, often led by regulations in dual-banking system, leading to inconsistencies in the application of *Mudarabah* principles. Due to higher interconnectivity among the conventional and PLS-based rates, lack of unique standardization for Islamic banks often creates volatility spillover between these two systems [19]. Rashid [13] underscores the need for a unified approach to *Shariah* compliance in participative financing, arguing that *Mudarabah* transactions face significant hurdles across jurisdictions due to differing views among *Shariah* scholars on what constitutes a compliant contract.

The governance structures within Islamic banks impede the widespread use of *Mudarabah*. Effective governance is crucial for ensuring compliance with *Shariah* principles while managing financial and reputational risks. Without robust governance, banks struggle to implement *Mudarabah* in a way that is both compliant and financially sustainable [1].

Trust between the financier and the entrepreneur is also vital for the success of *Mudarabah*, yet information asymmetry often undermines this trust. Yavuz and Saiti [27] propose blockchain technology as a solution to enhance transparency and trust in *Mudarabah* transactions. By recording all transactions on a decentralized ledger, blockchain can reduce misreporting risks and ensure that both parties have access to accurate, real-time information. This technological solution addresses a key issue in *Mudarabah*—the potential for entrepreneurs to underreport profits or exaggerate losses, which can harm the financier.

Several studies conducted on Arabian banks have examined the challenges associated with implementing *Mudarabah* contracts in Islamic banks. Samir [28] investigated the factors behind Algerian Islamic banks' hesitancy to extend *Mudarabah* financing, identifying multiple legal barriers imposed by the Central Bank of Algeria and the Money and Credit Act. These included predefined participation rates for banks, double taxation, and the absence of *Mudarabah*-specific laws in Algeria's civil code, all of which limited Islamic banking operations. Samir also highlighted *Mudarabah*-specific challenges, such as capital loss risk and insufficient restrictions on the *Mudarib's* activities.

Al-Jarrah [29] explored *Mudarabah* financing at the Islamic Bank of Jordan and found that despite a significant portion of the bank's funds being governed by *Mudarabah* contracts, they were rarely used for financing. The study examined constraints on *Mudarabah* financing within the bank and proposed solutions to activate its use.

Another study by Qawasmi [12] reviewed the financing and investment options of Palestinian Islamic banks, focusing on associated risks and risk management strategies. The study found that Palestinian banks, facing significant risk exposure, favored sales-based financing over profit-sharing models like *Mudarabah*. Furthermore, the existing banking regulations in Palestine did not adequately address the unique requirements of Islamic financial operations.

Based on the literature review, the research gap identified in this study focuses on the underutilization of Mudarabah financing in Islamic banks, particularly within the context of Palestinian banks. While existing research extensively discusses the theoretical principles and potential benefits of Mudarabah as a profit-and-loss sharing model, there is limited empirical analysis on the practical barriers that hinder its adoption in real-world banking environments. Most studies emphasize general challenges like agency problems, risk aversion, and regulatory concerns, but there is a lack of specific insights into how these issues manifest in the operations of Islamic banks in developing economies, such as Palestine.

Moreover, the existing literature does not sufficiently address the internal bank-specific factors, such as gaps in employee training, lack of expertise in Islamic finance, and ineffective client selection processes that directly impact the successful implementation of Mudarabah. Additionally, while some research highlights external challenges, such as clients' reluctance to share profits or provide transparent financial records, few studies propose actionable solutions tailored to the unique socio-economic and regulatory landscape of Palestine.

This study seeks to fill these gaps by providing a detailed qualitative investigation into both the internal and external challenges specific to Palestinian Islamic banks, offering practical, context-specific strategies to enhance the application of Mudarabah financing. By doing so, it extends the existing literature on Islamic finance by focusing on a region and a set of challenges that have been underexplored.

Research methodology

This study adopts a qualitative research design to explore the factors underlying the limited use of *Mudarabah* contracts for client financing in Palestinian Islamic banks. Given the exploratory nature of the research and the focus on understanding institutional perceptions and internal practices, a qualitative approach is most appropriate. It allows for in-depth insights into the attitudes, constraints, and reasoning processes of key decision-makers—insights that are difficult to capture through quantitative methods [30].

Data collection

This study employed a qualitative, exploratory research design to investigate the barriers to Mudarabah financing in Palestinian Islamic banks. Given the limited empirical literature on this topic in the local context, qualitative methods were selected to capture rich, practice-based insights that reflect institutional, operational, and regulatory dimensions.

A purposive sampling approach was adopted, informed by theoretical relevance and professional roles. Participants were selected based on their direct involvement in Mudarabah-related decision-making, including policy formulation, risk evaluation, and Shariah compliance. The sample consisted of twelve individuals representing three Islamic banks operating in Palestine—Palestinian Islamic Bank, Arab Islamic Bank, and Safa Bank—as well as two academic experts with direct affiliations to Shariah boards and Islamic banking education.

Importantly, the selection ensured diversity in both hierarchical levels and professional functions, including directors of risk departments, heads of corporate credit, Shariah auditors, legal supervisors, finance officers, and SME-focused staff. This variety enriched the data by capturing perspectives from both strategic and operational levels within the banking system. A detailed, anonymized list of participants is provided in Appendix Table 3.

Interviews were conducted until data saturation was reached, meaning no new themes emerged from subsequent interviews [31]. This confirmed that a comprehensive range of views had been captured relevant to the study's objectives.

Interview design

Data were collected through semistructured interviews, which offered a flexible yet consistent structure to explore a range of themes while allowing participants the freedom to elaborate on their experiences. The interview protocol was developed based on the research objectives and relevant literature, and it included open-ended questions to encourage candid dialog. This approach ensured both structure and spontaneity, allowing researchers to probe further into areas of interest as they emerged during the conversations [32].

All interviews were conducted in person and ranged from 45 to 90 min. Verbal consent was obtained from all participants, and anonymity was guaranteed to encourage openness. Ethical considerations, including participant confidentiality, voluntary participation, and data protection, were observed in line with qualitative research standards. For preserving anonymity, respondents from their respective institutions are coded as Acad (for academia), Pal (Palestinian Islamic bank), SAFA (for Safa Bank), and ARB (for Arab Islamic Bank). Table 1 summarizes the main themes explored and sample questions from the interview guide.

These dimensions were designed to explore a range of perspectives and factors influencing banks' decision-making processes. The structure allowed participants to provide detailed insights into their understanding and experiences

Table 1 Themes and guiding questions from interview protocol

Theme	Topics of interview sample questions
Bank policy and strategy	1. Bank policy on the provision of *Mudarabah* financing
	2. Perceived reluctance within the bank to employ the *Mudarabah* model for financing
	3. Reasons for the limited use of *Mudarabah* in the bank's financing portfolio
Staff knowledge and training	4. Staff knowledge of *Mudarabah*, both in practical and *Shariah*-related contexts
	5. Adequacy of training programs to support *Mudarabah* implementation
Environmental and market factors	6. Environmental and market factors in Palestine that influence the adoption of *Mudarabah*
	7. Specific challenges posed by the Palestinian economic context, including political and market instability
Target client characteristics	8. Target clients for *Mudarabah* financing and the development of tailored products to meet their needs
	9. Criteria used to select clients for *Mudarabah* financing
Legal and regulatory framework	10. Adequacy of the legal and regulatory framework in Palestine to support *Mudarabah* financing
	11. Specific regulatory challenges that affect the use of *Mudarabah* in Islamic banks
Proposed solutions	12. Suggested solutions to address existing challenges in *Mudarabah* financing
	13. Practical steps banks can take to enhance *Mudarabah* adoption and mitigate associated risks

with *Mudarabah*, ensuring the study captured both operational and theoretical challenges of implementing this contract and the banks' views on potential solutions.

Data analysis

Data were analyzed using a thematic analysis approach [33]. Interview transcripts were reviewed in multiple stages: initial open coding to identify recurring ideas, followed by axial coding to group these into broader themes and subthemes. Codes were refined and reviewed through iterative reading, and themes were triangulated with relevant secondary sources, including internal bank documents and regulatory texts, to ensure coherence and credibility.

To enhance reliability, coding decisions were discussed among members of the research team, and the data was revisited at several points to ensure consistency. While full intercoder reliability testing was not used, we followed the reflexive thematic analysis model and adhered to best practices in qualitative data validation [34, 35]. This analytical approach allowed the research to move beyond surface-level descriptions and capture deeper institutional and regulatory dynamics that influence the (under)utilization of *Mudarabah* financing.

Challenges of *Mudarabah* financing in Palestinian Islamic banks

Mudarabah financing faces several obstacles that limit its adoption in Palestinian Islamic banks, as evident in their annual reports. Table 2 provides a summary of the challenges and solutions to mitigate those challenges. Extent of *Mudarabah* financing among the Palestinian banks is limited, compared to other financing instruments. *SAFA1* from Safa Bank argued that this limited practice in their bank was due to limited experience, alongside other risks inherent to *Mudarabah* contracts. Succeeding discussions exhibit a host of internal and external factors inhibit the use of these contracts.

Table 2 Summary of the challenges and solutions of *Mudarabah* financing in Palestinian Islamic banks

Category	Challenges	Proposed solutions
Internal challenges		
Human resources	Lack of clear roles and responsibilities	Clearly define roles and hire *Shariah*-compliant finance experts
	Limited Islamic finance literacy	Prioritize hiring knowledgeable, committed staff
	Insufficient *Shariah*-specific training	Implement targeted training and certifications
Bank credit policies	Hesitation to use depositor funds for *Mudarabah*	Allocate bank funds specifically for *Mudarabah*
	Inadequate risk management for depositor protection	Create reserve funds for losses
		Offer *Mudarabah*-specific investment portfolios
Organizational process	Ineffective fund management	Conduct market research for viable investments
	Limited direct control over client operations	Organize field visits to monitor projects
		Offer phased disbursement approach to assess client reliability
External challenges		
Bank clients	Trust issues with the clients	Establish a client database for detailed risk assessment
	Reluctance to share profits	Prioritize compliant clients for *Mudarabah*
Interbank cooperation	Limited resource pooling and data sharing	Promote collaboration for risk-sharing
		Standardize frameworks for *Mudarabah* practices
Challenges inherent to Mudarabah contracts		
Oversight and monitoring	Sole control by *Mudarib* increases risk for the bank	Frequent site visits and reporting requirements for oversight
	Lack of active supervision	Share control functions among stakeholders
Proof of infringement and default	Difficulty proving *Mudarib* infringement	Define clear terms for infringement and default
		Shift burden of proof to the *Mudarib* for compliance

Internal challenges related to human resources

The National Bank (a commercial bank) acquired Palestinian Islamic Bank in 2018, and Bank of Palestine acquired Arab Islamic Bank in 2016, bringing in executives with experience in commercial banking. According to *Acad1*, bank management in Palestine possessed substantial experience. However, this experience influenced them favoring less risky sale-based financing models resembling conventional loans, such as *Murabaha* and *Musawama*, placing less emphasis on *Mudarabah*.

Despite recruiting from existing banks, employees managing key positions in Palestinian Islamic banks suffer from lack of a solid grounding in Islamic banking, laws, and operational issues. *Acad1* mentioned several cases where financing was extended for prolonged periods without proper oversight, resulting in financial losses for the bank.

Similar challenges causing banks to lose money demands Palestinian Islamic banks to arrange employee training on *Shariah* supervision and auditing. However, as *ARB6* and *SAFA2* noted, these training sessions did not adequately cover *Shariah*-specific issues related to *Mudarabah* financing. As expected, most training programs concentrated on widely used models like *Murabaha*, serving the most important clients. While training sessions often conflict with staff workloads, relying on other colleagues on core *Shariah*-related information exacerbated internal human capital challenges, hindering effective implementation of *Mudarabah* financing in Palestinian Islamic banks.

Internal challenges associated with credit policies of banks

"Clients seeking *Mudarabah* financing must meet stringent criteria", argued by *ARB3*. These criteria include auditing financial statements by reputable firms, such as the Big-Four or the Talal Abu Ghazala group, implementing internal control systems with dedicated internal audit teams, utilizing solid accounting systems to record business transactions, and offering traditional collaterals. Meeting these criteria is extremely difficult for Palestinian firms [36], indicating a lesser demand from the entrepreneurs.

Pal1 and *ARB1* stressed on the need for financial guarantees to subside the negative impact of prolonged political instability in Palestine—primarily due to the Israeli occupation. In *Mudarabah,* the financier bears the loss unless it is due to negligence or misconduct by the manager (*Mudarib*). The usual tendency to risk aversion by Islamic banks disfavors *Mudarabah*, where guarantees cannot be enforced without needing to prove client negligence or misconduct. *ARB6*, *SAFA2*, and *Pal2* emphasized that Islamic banks invest less using *Mudarabah* as they want to reduce displaced commercial risk, ensuring competitive profit for deposit customers (Table 3).

Internal challenges in managing *Mudarabah* financing

Several respondents identify lack of oversight by banks on the client's business as a major challenge while dealing with *Mudarabah* financing (*ARB5*, *ARB2, ARB3,* and *ARB1*). Hence, *Mudarabah* is often reserved for large companies with established management systems, depriving the real spirit of profit-and-loss sharing and development of SME and start-up sectors. The bank's inability to actively manage *Mudarabah* operations raises concerns about potential losses and risks to depositor funds.

Financing a genuine business idea using *Mudarabah* has been challenging in the Palestinian context due to a long history of political uncertainty, aim of short-term profit maximization, and lack of trust between clients and banks (*Acad1*). Due to relatively smaller size of the economy and strong community cohesion [9], smaller business ideas are financed within the community, without any help from banks. These business and cultural tendencies structurally weakens the appeal of *Mudarabah* financing.

External challenges associated with bank clients

The relationship between banks and clients in *Mudarabah* financing theoretically resembles a family, which requires clients to be trustworthy, transparent and experienced. However, pointed out by *SAFA2*, "the widespread weakening of Islamic values, prevalent corruption, contract non-compliance, and lack of commitment" make it difficult for banks to identify suitable *Mudarabah* clients. As a result, banks have tightened funding policies to mitigate potential losses. Furthermore, "the informal and unregulated nature of the Palestinian market, along with clients' lack of credible, audited financial records", reduces banks' confidence in investing with these clients (*ARB3*).

Many clients are unwilling to allow the bank to share in the profits of successful ventures (*ARB4*, *Pal2*, *ARB6*, and *Pal3*). Ethical misconduct has also been observed, as such, certain clients have applied for *Murabaha* financing to purchase goods, only to circumvent the bank by returning the goods to the merchant for cash. Similar deceptions discourage the banks financing using *Mudarabah* contracts.

External challenges in interbank relations

Several respondents (*ARB1*, *SAFA1*, *ARB4*, and *Pal3*) acknowledged that banking secrecy significantly influences client behavior, hindering effective interbank cooperation. Sharing of information on client's capacity to pay is particularly concerning to many clients and banks. A quality credit assessment system fails to work effectively due to limited collaboration among banks and with the Palestinian Monetary Authority (PMA).

External challenges in the regulatory environment

The regulatory environment for *Mudarabah* financing in Palestine remains underdeveloped and outdated. While the PMA mandates Islamic banks to comply with the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards, this requirement is general and applies uniformly to all Islamic financial institutions. It does not provide specific regulatory guidance or enforceable legal mechanisms for risk-sharing contracts such as *Mudarabah*.

Furthermore, the primary legal framework governing contracts remains the *Majallat al-Ahkam al-Adliyya*, an Ottoman-era civil code issued in 1876, which is still legally effective in Palestine. This code approaches *Mudarabah* from a classical *fiqh* perspective, treating it as a contract between individuals rather than institutions. As such, it fails to account for the institutional, risk-based, and contractual complexities of modern *Mudarabah* applications in banking. Additionally, new financial innovations such as *Mudarabah* sukuk and diminishing *Mudarabah* structures are entirely absent from the current Palestinian regulatory system. This legal vacuum creates significant uncertainty for Islamic banks, which are left without a comprehensive framework to support, monitor, or enforce *Mudarabah* contracts at scale. The situation underscores the urgent need for updated, sector-specific legislation to address the evolving landscape of Islamic finance in Palestine.

Other challenges inherent to the *Mudarabah* contract

Client's sole responsibility in decision-making is a challenge inherent to the *Mudarabah* contract. According to *Acad1* and *ARB5*, the autonomy enjoyed by the client discourages banks from expanding *Mudarabah* use, as concerns exist over clients' ability to sustain economic activities and the potential for losses.

In *Mudarabah* financing, the burden of proving infringement and default lies with the bank. However, limited bank oversight complicates the demonstration of any wrongdoing by the *Mudarib*. *ARB5* noted that the absence of legal controls governing these aspects discourages the banks.

Unlike traditional financing, where banks can refer to guarantees in cases of client default, *Mudarabah* contracts lack such recourse. Banks can only invoke guarantees if they can prove terms were violated, necessitating investments with highly credible clients who possess the experience to manage investment risks, as noted by *ARB3*.

Proposed solutions for expanding *Mudarabah* financing

Based on the insights shared by the interviewees, this research proposes solutions to address challenges and broaden the application of *Mudarabah* financing. The proposed solutions are organized into three categories corresponding to the previously discussed challenges: (1) proposed solutions to internal challenges, (2) proposed solutions to external challenges, and (3) proposed solutions to challenges associated with the nature of the *Mudarabah* contract.

Managing inadequate human skills

Bank administrations

One key challenge in adopting *Mudarabah* financing is the lack of clear roles and responsibilities among staff, leading to miscommunication and inefficiencies. Bank administrations should clearly define responsibilities to ensure that both clients and staff understand their roles in *Mudarabah* contracts. Employing experts and specialists in *Shariah*-compliant finance is crucial for navigating *Mudarabah* complexities and adhering to Islamic principles [1].

Most interviewees emphasized the importance of appointing *Shariah* compliance officers with expertise in Islamic finance to mitigate risks. Pal1 noted that such officers can ensure *Mudarabah* contracts are structured to minimize legal and operational risks, aligning practices with Islamic values. By fostering a deeper understanding of the legitimate controls and risks associated with *Mudarabah*, bank administrations can build trust and confidence in these products among both staff and clients [20].

Employee selection

The selection of employees is essential for the success of *Mudarabah* financing. Banks must prioritize staff who not only possess technical expertise but also show commitment to Islamic banking principles. *ARB4* highlighted that hiring employees knowledgeable in Islamic finance, especially in areas where it contrasts with traditional banking—ensures that *Mudarabah* is conducted in a truly Islamic manner [15]. A restructuring of the hiring process is needed to align staff selection with *Shariah* compliance objectives, which can enhance the bank's reputation and trustworthiness within the community [4]. Committed, *Shariah*-conscious staff ensure that clients receive financial services that are both ethical and compliant.

Staff training

Continuous training is essential to address knowledge gaps among employees, especially in Islamic banking [3]. Bank training departments should design targeted programs specifically focused on *Mudarabah* and other *Shariah*-compliant contracts. Collaboration with managers is key to identifying training needs and scheduling courses to ensure that staff develop the skills necessary to promote and manage *Mudarabah* effectively [22].

Incentivizing staff through certifications in Islamic finance can deepen their understanding of the ethical and legal principles underpinning *Mudarabah*. *ARB6* suggested that exams and certifications from reputable professional organizations could strengthen commitment and encourage professional growth, creating a culture of continuous learning. This approach ensures that bank staff are well-prepared to handle the complexities of *Mudarabah* contracts [1].

Upgrading bank's credit policy

Allocating bank funds for *Mudarabah* financing

One significant barrier to *Mudarabah* adoption is banks' hesitation to use depositor funds for high-risk, profit-and-loss sharing ventures. To address this, it is recommended that banks allocate a portion of their own funds to *Mudarabah* financing, thereby reducing depositor exposure to potential losses [1]. Using internal resources allows banks to maintain control over risk management and decision-making while adhering to *Shariah* principles. According to *ARB1*, this approach would build depositor confidence, as their funds would not be directly exposed to *Mudarabah's* inherent risks [4]. This shift could mitigate risks and encourage banks to incorporate *Mudarabah* more extensively in their portfolios.

Establishing reserve funds

To manage *Mudarabah* risks, banks should consider establishing reserve funds specifically dedicated to offsetting potential losses. These funds would serve as a buffer, absorbing the impact of unsuccessful investments and safeguarding depositors and the bank's financial stability [22]. *ARB3* suggested that reserve funds could be built from profits generated by successful *Mudarabah* contracts, creating a self-sustaining risk management system. This approach aligns with Islamic principles by ensuring that risks are equitably distributed between the bank and its clients while maintaining financial prudence [2]. Implementing reserve funds would allow banks to expand their *Mudarabah* portfolios without excessive exposure to risk.

Investment portfolios for *Mudarabah* financing

Banks could also offer investment portfolios specifically designed for *Mudarabah* financing, enabling clients to invest in *Shariah*-compliant projects with predefined profit-sharing ratios and risk distribution terms. According to *Pal2*, transparency is crucial in *Mudarabah* contracts, especially concerning loss handling. Offering predefined portfolios would prevent conflicts by establishing a clear framework for managing profits and losses, ensuring that both parties understand the terms from the outset [3]. This structured approach would also allow banks to diversify *Mudarabah* investments across sectors, reducing exposure to the failure of any single investment [20].

Improving transparency and conflict prevention

Transparency is key to maintaining trust in *Mudarabah* contracts. Establishing clear terms for handling losses, especially in cases of project failure, helps avoid disputes [18]. *ARB5* recommended implementing comprehensive disclosure practices to outline the specific conditions under which profits and losses will be shared. This proactive approach not only shields banks from potential legal conflicts, but also fosters stronger relationships with investors, as they can make more informed decisions [4].

Improvement of organization and policies

Conduct market research to identify viable investments

One primary reason for the underutilization of *Mudarabah* financing is banks' hesitation in identifying viable investment opportunities. Conducting thorough market research to assess potential sectors and businesses suitable for *Mudarabah* financing can help build confidence. By using market-based assessments, banks can select industries or sectors that align with both *Shariah* principles and sound financial practices [1]. Such research can also help identify lower-risk sectors for *Mudarabah* contracts, thereby increasing success rates and minimizing potential losses [22]. For instance, family-owned businesses, which are prominent in the Palestinian market, require specific approaches and careful evaluation, as emphasized by *ARB6*, before engaging in *Mudarabah* contracts [2].

Field visits

Organizing field visits is another effective solution for ensuring compliance and oversight in *Mudarabah* financing. By conducting regular site inspections, bank representatives can verify that the terms of *Mudarabah* contracts are being adhered to and that investments are used appropriately [3]. According to *Pal2*, these visits help confirm client compliance with legal and *Shariah* conditions, enhancing transparency and accountability. Field visits also allow the bank to identify and address potential issues early, fostering stronger relationships with clients and providing a direct oversight mechanism for *Mudarabah* ventures [4].

Provide financial and administrative guidance

Due to the complexity of the *Mudarabah* model, especially in markets like Palestine with many family-owned businesses, banks should provide comprehensive financial and administrative support to clients [20]. Many small businesses lack the financial literacy and administrative skills needed to manage *Mudarabah* funds effectively, which can lead to poor decision-making [2]. *ARB5* recommended that banks offer guidance in areas like business planning, financial reporting, and risk management to help clients navigate *Mudarabah* contracts successfully. This support fosters stronger partnerships between the bank and client, ensuring the successful implementation of financed projects.

Periodic status reports

To ensure transparency and proper use of *Mudarabah* funds, banks should require clients to submit periodic reports on their investment status. Collecting these reports both before and during the financing period allows banks to monitor project progress and detect issues early [3]. *ARB4* suggested that regular reporting increases accountability and keeps the bank informed on the state of investments. These reports also create a valuable feedback loop, helping banks assess financing effectiveness and identify adjustments needed for improved outcomes [22].

Improve competency and reliability of clients

To minimize risk and ensure clients can manage *Mudarabah* funds responsibly, banks should consider a phased disbursement approach, in which financing is released in stages, contingent upon the client's progress or fulfillment of agreed-upon milestones. This "phased Mudarabah" model can enhance oversight and align financial commitment with real economic performance. Starting with smaller amounts allows banks to assess the client's reliability and commitment [1]. As clients demonstrate competence and adhere to contract terms, banks can gradually increase funding and eventually raise credit ceilings once reliability is proven [20]. This phased approach minimizes exposure to risk and supports a secure, sustainable financing relationship. As *ARB1* noted, by scaling investments based on client performance, banks can strengthen their *Mudarabah* portfolios and promote growth in this financing model.

Solutions to external challenges

Client information system

Taking a client-centric approach helps banks build long-term engagement with reliable clients and to mitigate client-specific risks. To enhance the suitability of *Mudarabah* financing for clients, banks should establish a comprehensive client information system database containing detailed information on clients' banking transaction history, cash flows, economic activities, and a risk assessment profile. *ARB4* suggested that banks use client information system to identify the right client. Clients with healthy cash flows and responsible financial practices should be prioritized for *Mudarabah* financing [4]. This database would allow banks to perform thorough economic feasibility studies before approving *Mudarabah* contracts, thereby minimizing risks associated with profit-and-loss sharing [3]. By providing insights into each client's financial behavior and risk profile, banks can ensure that only competent and trustworthy clients are offered *Mudarabah* financing [22].

Harmonize interbank collaboration

Interbank cooperation is essential for *Mudarabah* financing, allowing banks to pool resources, share risks, and collaborate on investment opportunities that may be too large or risky for a single bank to undertake independently [2]. On a broader scale, Islamic banks need to reassess their cooperation mechanisms to safeguard the interests of the Islamic banking sector and to facilitate the wider adoption of participatory financing models like *Mudarabah* [1]. *ARB1* emphasized that fostering greater collaboration among Islamic banks would better align savings with investments, and channeling capital into real economic activities that benefit society. Collaboration with other banks increases the opportunity to fund projects that generate both social and economic value, including infrastructure development, SME support, and social welfare programs [4]. Also, enhanced interbank cooperation supports Islamic banks during economic downturns, fostering sustainable growth within the sectors they serve [20]. Standard legal frameworks would help Islamic banks mitigate risks and address regulatory ambiguities that currently hinder the full adoption of *Mudarabah* contracts [13].

Solutions to challenges inherent in the *Mudarabah* contract

To address challenges inherent in *Mudarabah* contracts, it is essential to enhance the bank's oversight role and implement clear solutions for proving infringement and default. These measures will protect the bank's interests and strengthen trust between the bank and its clients, ensuring *Shariah* compliance and mitigating risks.

Activate the bank's oversight role

A significant challenge in *Mudarabah* financing is the potential for agency conflict between the client and the bank. To mitigate this conflict, banks should take a more active role in terms of periodic visits and monitoring progress [3]. *ARB3* emphasized that such visits provide opportunities to evaluate the client's adherence to contract terms and compliance with *Shariah* and other legal requirements [2]. Additionally, banks should require regular reports from clients detailing their *Mudarabah* activities and financial status for transparency, enabling the bank to forecast outcomes more accurately and intervene if necessary [4]. By adopting a proactive oversight role, banks can minimize risks associated with *Mudarabah* contracts, ensuring projects are managed efficiently and in line with contractual terms.

Solutions for proof of infringement and default

One critical challenge in *Mudarabah* financing is addressing situations where the *Mudarib* may infringe upon contract terms or default on obligations, as noted by *ARB5*. To address this, banks must establish clear, mutually agreed definitions of what constitutes infringement and default. These definitions should be tailored to the specific economic activities involved and clearly outlined in the contract to prevent misunderstandings [1]. For instance, the contract could specify breaches like intentional mismanagement, failure to disclose key information, or non-compliance with *Shariah* guidelines [20].

In line with the suggestion by *ARB4*, an additional solution is to transfer the burden of proof to the *Mudarib* in cases of alleged infringement or default. This approach aligns with Islamic customs and legal practices, where the party managing operations (the *Mudarib*) is responsible for demonstrating contract compliance [18]. Consequently, this shift will ensure accountability and fairness from both sides.

Conclusion

Summary of the findings

The study finds that, analogous to other jurisdictions, *Mudarabah* financing in Palestinian Islamic banks is significantly limited due to internal and external challenges. Internally, many bank personnel lack the necessary expertise and training to manage *Mudarabah* clients, leading to financial loss to the banks and the deposit customers. Externally, lack of transparency with financial records and agency conflict inherent to the credit policy of the banks and the *Mudarabah* contract itself indicate lower control by banks and higher risk of default. Minimal bank supervision, limited client monitoring, and difficulty proving contract violations further restrict *Mudarabah* financing. These factors collectively push banks to favor lower-risk, asset-based financing models like *Murabahah* and *Ijarah*.

Implications

The findings underscore the need for targeted, practical measures to enable the effective use of *Mudarabah* financing. The study discusses the implications from institutional as well social aspects.

Banks should establish specialized training programs that deepen employees' understanding of *Mudarabah* and other Islamic finance principles. This includes not only theoretical knowledge but also practical applications, covering areas like risk assessment, client selection, and contract management. Training should be ongoing, with certification opportunities and incentives, to ensure staff remain up to date on best practices and regulatory changes.

Building a client database with detailed information on transaction history, cash flows, and risk profiles would enable banks to make better-informed decisions when selecting clients for *Mudarabah* financing. This database could help banks proactively identify suitable clients, particularly those with a demonstrated ability to manage funds responsibly. Additionally, a data-driven approach would allow banks to assess potential clients' alignment with *Shariah* principles, minimizing risks associated with transparency and compliance. In this regard, banks could benefit from blockchain-based management of client's data, ensuring data safety and privacy, and also intra-bank collaborations to share information across border to strengthen *Mudarabah* ecosystem.

Banks should consider implementing blockchain or similar transparency-enhancing technologies to reduce the impact of asymmetric information. Blockchain, for example, can create an immutable, decentralized record of transactions, ensuring both parties have access to accurate information in real-time. This innovation could reduce the risk of misreporting and build greater trust between banks and clients.

Yaya et al. [5] find that Islamic banks segment profit-and-loss sharing financing and prefers short-term (3 years and less) than long-term contracts. Following this suggestion, basing on a venture capital management approach, Islamic banks should implement a phased approach to *Mudarabah* financing, where initial financing amounts are kept low, gradually increasing as clients demonstrate reliability and adherence to contract terms. This phased disbursement approach helps reduce exposure to high-risk clients and fosters a disciplined approach to investment.

Establishing reserve funds specifically allocated for *Mudarabah* contracts would provide a financial cushion, offsetting losses in case of failed investments. This self-sustaining fund could be built from a portion of profits generated from successful *Mudarabah* contracts. Such a fund would reassure depositors and support the bank's ability to handle the unique risks associated with profit-and-loss sharing arrangements. Similar to our earlier suggestion, this unique reserve fund can be developed in consortia with other banks and financial institutions, providing essential risk and liquidity management facilities. Gradually, this initiative could grow toward an institution similar to Islamic interbank money market (IIMM) of Malaysia.

Islamic banks need to work closely with other banks, regulatory bodies and standard setters to develop clear definitions of terms like "infringement" and "default" within *Mudarabah* contracts, tailored to specific economic activities. Transferring the burden of proof for compliance to the *Mudarib* can help streamline dispute resolution and encourage stricter adherence to contractual obligations. Another initiative is in the application of IFSB-15 while deciding risk weights for *Mudarabah* financing. Previously, both Malaysian and Indonesian banking system asked banks to keep up to 400% risk reserves, which was impeded banks capacity to facilitate these investments. Now, central banks of both countries eased the risk weights based on internal ratings approach [14], indicating a paradigm shift in regulatory support for banks to finance using *Mudarabah*.

As Islamic banks are less interested about equity-based financing [14, 37], regulators should carefully balance their role between the entrepreneurs and the capital providers in the *Mudarabah* contract. To reduce risk, central bank should design a collateral and business finance support system, similar to the *Kafala* system used in the Saudi banking system. Regulators may also help in developing an international market for the products of these entrepreneurial process. However, the best approach of the regulators would be to train the bankers to master business management, so that they can identify potential businesses generating positive cash flows.

In the context of Palestine, these implications carry particular weight. The country faces a unique combination of political instability, restricted economic mobility, limited legal recourse, and a largely informal market structure. These conditions elevate the perceived risks of profit-and-loss sharing models such as Mudarabah. However, when implemented strategically, Mudarabah can become a vital instrument for promoting financial inclusion and supporting micro- and small enterprises that are often underserved by traditional credit mechanisms. In post-conflict economies like Palestine, where entrepreneurial activity is essential for livelihood and resilience, a revitalized Mudarabah framework—backed by institutional reform, smart risk management tools, and regulatory innovation—can offer banks a Shariah-compliant means to foster equitable and sustainable economic growth. Policymakers, therefore, must align regulatory efforts with developmental priorities, ensuring that Mudarabah financing evolves from theoretical possibility to practical policy tool.

Limitations and future research

This study focuses specifically on Palestinian Islamic banks, which may limit the generalizability of findings to other regions with distinct economic and regulatory environments. Future research could broaden these insights by examining *Mudarabah* practices in a range of Islamic banking contexts. Comparative studies across different regulatory frameworks and economic conditions would provide valuable guidance on adapting *Mudarabah* to diverse markets. Quantitative assessments of the impact of training, technological advancements, and regulatory changes on *Mudarabah* performance and risk management would further validate and refine these proposed solutions.

Appendix

See Table 3.

Table 3 Table of interviewees

Code	Initials	Job title/position
Acad1	A.A	Lecturer in the Islamic Banking Department—An-Najah National University
Pal1	A.R	Chairman of the Shariah Supervisory Board at the Palestinian Islamic Bank and Head of the Islamic Banking Department at An-Najah National University
Pal2	M.Sh	Staff member of the Palestinian Islamic Bank closely related to credit policies, who wished to remain anonymous
Pal3	Y	Finance Officer—Palestinian Islamic Bank
ARB1	S	Director of the Risk Department—Arab Islamic Bank
ARB2	T	Shariah Auditor—Arab Islamic Bank
ARB3	A.Sh	Head of Corporate Credit Department—Arab Islamic Bank
ARB4	A.Q	Direct Sales Supervisor for Small and Medium Enterprises—Arab Islamic Bank
ARB5	A.D	Legal Department Supervisor—Arab Islamic Bank
ARB6	R	Staff member of the Arab Islamic Bank closely related to credit policies
SAFA1	A.H	Director of the Risk Department—Safa Bank
SAFA2	M.A	Staff member of Safa Bank closely related to credit policies

Declarations

Conflict of interest On behalf of all authors, the corresponding author states that there is no conflict of interest.

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