TRADE-BASED FINANCING

MURABAHA (COST-PLUS SALE)

- The early models of Islamic banks are based on partnership of *mudharaba* and *musharaka* (profit-loss sharing) structure. Such equity-based financing are perceived to be superior to conventional financing from the standpoint of robustness to external shocks and from the standpoint of ethics, fairness and social justice.
- Where profit-loss sharing mechanisms cannot be used, Islamic banks provide other contracts and services that are legally binding and lawful under *Shari'a* law and Islamic principles.
- Subsequent models of Islamic banks use an expanded framework and include debt-based mechanisms, such as*, murabaha, bay'-bithaman-ajil (BBA), ijara, salam, istisna', istijrar and qard-hasan.* The list also includes debt-products that involve *tawarruq, bay'-aldayn, and bay'-al-einah,* that are either rejected or at best deemed controversial by mainstream Islamic scholars.

THE CONCEPT OF MURABAHA

- ***Murabaha*** is a contract of sale where the seller discloses to the buyer the actual cost of the item to be sold in addition to the profit margin (mark up) added, to be mutually agreed upon with the buyer.
- It is important to note that in classical *fiqh*, *murabaha* refers to sale (*bay'*), with all its implications and prescribed *Shari'a* conditions pertaining to sale, and has nothing to do with financing in the conventional sense.
- When used as merely a means of circumventing the prohibition of *riba*, it is not an ideal instrument to implement the real economic objectives of

Islam. Its use should be limited to circumstances where equity-based arrangements such as *mudaraba* or *musharaka* are not practicable.

- *Murabaha* financing is a widely used contract in contemporary Islamic banking and finance; and it is limited to cases where the customer actually needs to purchase some commodity.
- As a result, there are a number of contentious issues relating to the application of *murabaha* in trade financing. These issues do not question the permissibility of *murabaha* as a valid contract but rather the manner of implementation of *murabaha* as well as specific terms and conditions related to its use in modern day trade financing
- With regard to Islamic banking, *murabaha* is an agreement wherein the bank purchases, at the request of a customer, a specified item, and then sells it to him at a mutually agreed marked-up price.
- *Murabaha* is different from *musawama*, where the commodity is sold for a lump sum price without any reference to the cost
- Payment for goods under *murabaha* may be made either on cash basis or under deferred payment terms. Although common usage of *murabaha* in trade financing is typically done by way of deferred payment, by definition, *murabaha* is not exclusively a deferred payment sales
- To understand *murabaha* concept we have to link it first to *Bay' bithaman ajil (BBA)* or simply *bay' mu'ajjal*.

Bay' Bithaman Ajil (*BBA*)

- ***BBA*** means sale with deferred payments i.e. Bay' = sale, thaman = price, Ajil= deferment.
- ***BBA*** is a *Shari'a* approved sale where the good is delivered upfront but the payment of price is deferred to a future date. Often it includes features of a *murabaha*, which implies a sale on a cost-plus / profit margin basis. Selling price is the price stated in the contract and cannot change throughout financing period.

- ✧ In determining the selling price, the bank sets the profit margin rate per annum, say 5%. Suppose the cost price (CP) = $100,000 and the financing period = 10 years. Then,
- ✧ the total profit margin (TPM) = (0.05 x $100,000) x 10 = $50,000 and the selling price = CP + TPM= $100,000 + $50,000 = $150,000

SHARI'A BASIC RULES OF SALE

- ✧ A *murabaha* transaction does not become valid simply by replacing the term "interest" with "profit" or "mark-up". All the conditions stipulated by the *Shari'a* in relation to a *murabaha* transaction must be observed to ensure *Shari'a* validity
- ✧ *Shari'a* therefore, imposes several constraints and prescribes certain norms in order that a *murabaha* facility is free from riba and gharar.

<u>Subject of Murabaha (Item for Sale)</u>

- ✧ Subject of sale must be specifically known and identified.
- ✧ Subject of sale must be in existence at the time of sale, and must be owned by the seller at time of sale.
- ✧ Subject of sale cannot be for *haram* use or forbidden commodities
- ✧ Subject of sale must be something of value and classified as property in fiqh. This may raise several important fiqh issues, such as, whether "rights" qualify as property or not.
- ✧ Sale must be instant and must not be attributed to a future date
- ✧ Terms of delivery must be specified and certain.
- ✧ Sale must be unconditional and must not be contingent on a future event or fulfillment of a condition that is external to the transaction.

<u>Specification of Price</u>

- ✧ A requirement of a valid sale is knowledge and specification of price and payment terms- spot or deferred. In case of deferred payment, the terms, such as, maturity, amount and timing of installments must be clearly specified at the time of contracting to avoid any gharar or uncertainty as a source of potential conflict between the parties.

- The deferred price may be more than the cash price, but it must be fixed at the time of sale. Once the price is fixed, it cannot be increased in case of default; nor can it be decreased in case of early payment.

IMPLEMENTATION ISSUES IN MURABAHA FINANCING

- A *murabaha* facility at times may appear similar to conventional bank financing; and it may look like substituting profit rate or mark-up for the rate of interest. Indeed the distinction between the two may disappear if proper care is not exercised in the practice of *murabaha*.
- The following are some important issues that help preventing an abuse of the system in dealing with *murabaha*.

Risk and Return

- In line with the *Shari'a* maxim of "revenue goes with liability", the bank must bear a certain amount of risk associated with ownership, such as price risk, risk of destruction of asset etc. to legitimize its returns.
- In order to ensure that the bank's gains are above all suspicions of riba, the bank must have the ownership and possession of the item before it can sell it to the customer. Possession may be physical or constructive. Constructive possession means a situation where the bank has not taken the physical delivery of the item, yet it is in control of the item with all the rights, liabilities and risks, including the risk of destruction.
- In modern day trade and commerce, physical possession may not matter in the presence of adequate documentation showing ownership and constructive possession.
- Does the risk bearing by the bank even if for a short time period legitimize bank's profits in the eyes of *Shari'a* as distinct from prohibited riba?

Legal Nature of Promise

- ✧ An actual purchase or sale is different from a mere promise to buy or sell. The customer is required to make a unilateral promise to buy the commodity from the bank, before the bank makes the purchase
- ✧ The bank has to purchase the requested commodity before selling it to the customer. If the customer decides not to purchase the commodity after the bank has bought it, the bank faces risk of not being able to sell the commodity at the right price and hence suffering financial loss.
- ✧ The question is, is the customer's promise legally binding and can the bank seek legal enforcement of the promise in the court of law or is it just a moral obligation?
- ✧ Promise is legally binding if the promisee has incurred liabilities/losses; and the court can force the sale or require the promisor to pay actual loss
- ✧ This legal enforcement of promise is important to ensure the stability, sanctity and solidarity of commercial transactions.
- ✧ If a promise is not enforceable in a court of law, this may create a difficult situation, especially where price of the item happens to be extremely volatile. Depending upon how price moves between the time of first contract (between the bank and the seller) and the second contract (between the bank and the customer) either of the parties would have an incentive to default. For instance, if the price decreases after the first contract, a buyer may decide not to buy the item from the bank (since it can now buy it from the market at a lower price). The converse would be true when the price rises after the first contract. In this case, the bank would have an incentive to sell the item to the market at a higher price. In both cases, there may be a breach of promise and hence the other party may suffer financial losses.
- ✧ Whether a promise involves a moral or a legal obligation perhaps depends on the nature of the promise.
    - o A unilateral promise to make a gift cannot obviously be enforced through courts. It creates at best, a moral obligation.

- However, in commercial dealings, where a party incurs a liability on the basis of a promise by another party, it is only fair that such a promise should be legally enforceable. This is the case with *murabaha*.

Profit Rates and Benchmarks

- In *murabaha*, price includes a known profit or mark-up. The mark-up in *murabaha* is part of the sale price, it is set only once and then it does not change overtime.
- The bank can calculate the mark-up price (cost-plus) in any way even basing such calculation on the market interest rate, such as, the LIBOR (London Inter Bank Offering Rate) or BLR (Base Lending Rate).
- This naturally leads to a suspicion that *murabaha* is no different from conventional lending. The question that can be raised is whether it is islamically correct for the Islamic bank to use the LIBOR or BLR to calculate the markup price.
- Although such practice gives the appearance of *riba*, the *Shari'a* validity should be assessed on the basis of the contract elements. As long as all *Shari'a* conditions and stipulations are met, the *murabaha* transaction should be *halal*.
- It is natural and legal for a depositor in Islamic bank to benchmark his/her expected return against what is being offered by conventional banks. Therefore, it is also natural and legal for an Islamic bank to benchmark its *murabaha* rates against lending rates charged by conventional banks since rates on both Islamic and conventional financial products to align with each other, especially in an integrated market comprising both types of products.
- In addition, the Islamic financial system is still too small and too young compared to the conventional one and does not have the ability to have its bench mark that can govern the whole Islamic financial system internationally.

- However, using *riba*-based rates as a point of reference is not desirable and should be avoided. Such dependency might influence the manner of operation of *murabaha* transactions, mimicking conventional interest-based loans, and could lead to a convergence between Islamic and conventional banking.
- Islamic financial system must find an innovative way to develop its own benchmarking to use it in calculating *murabaha* mark-up prices and in any other uses.
- Islamic finance should avoid linking itself to riba-based methodologies.

Spot and Deferred Prices

- Payment of prices in a *murabaha* contract could be in cash (spot payment) or credit (deferred over subsequent periods).
- Does this mean that the deferred price in *murabaha* is the same as cash or spot price?
- According to majority of scholars, the deferred price may be more than the cash price, but it must be fixed at the time of sale. The reason for this permissibility perhaps lies in the fact that the seller can charge varying prices with an absolute freedom in the matter.
- In addition, it is important to distinguish between the opportunity costs of a trader and a lender. By selling on credit, the trader gives up repeated opportunities to use the spot money, he could get, to buy new merchandise and sell for profits. In the case of pure lending, money is not a commodity to be traded. Money cannot create money.
- Regardless, at the time of contracting, parties must clearly specify the nature of price and payment - spot or deferred. In case of deferred payment, the terms, such as, maturity, amount and timing of installments must be clearly specified.

Fixed and Floating Profit Rates

- A point of difference between *murabaha* and conventional lending that has major practical implications relates to volatility in rates.
- Interest rates are observed to be volatile and many conventional banking products are floating-rate products. The rates on such loans are automatically adjusted upwards or downwards in line with changes in interest rates.
- *Murabaha* financing products are, on the other hand, fixed-rate products. The rate, once determined for a given contract, is not allowed to float with changes in the interest rates or any other rate.
- You may note here that a fixed rate facility may be converted into a floating rate facility by making the debt roll-over at periodic intervals. At the end of a specific time period, a new fixed rate (reflecting current market conditions) replaces the old rate. While this is a possibility in case of conventional bank loans, *murabaha* does not permit a roll-over. A rollover in *murabaha* would imply that another separate *murabaha* is booked on the same item. This practice needless to say, is not only counter-intuitive, but also inadmissible in *Shari'a*.

Default Risk and Its Mitigation

- A major problem associated with *murabaha* financing relates to a possibility of default by customers.
- In the case of default or delinquency, the conventional financial system penalizes the borrower with additional interest, which is deemed as a compensation for the delay or time value of money. Since the amount of compensation is determined with reference to the interest rate it is deemed to be a case of the prohibited riba. Hence, such practices are not allowed in case of *murabaha*.
- Selling price of *murabaha* transaction cannot be increased after contract concluded. Unscrupulous debtors may deliberately delay or avoid

payment to exploit this. The issue is whether banks can impose a penalty in the event of delinquency in payment

- As far as dealing with the problem of delays and delinquencies, various alternatives have been suggested.

  1. One alternative is to require the customer-in-default to donate a specified amount for a charitable purpose as financial penalty. Such a penalty does not form part of the income of the bank and hence, does not compensate the bank either partially or fully for its cash flow problems caused by delays and delinquencies. It merely acts as a disincentive.
  2. Another view suggests that customers who default in payment deliberately may be made liable to pay compensation to the bank for the loss. However, there should be additional safeguards to ensure that the default is indeed willful and deliberate.

     In practice, many Islamic banks charge their customers some fees for the delay of payments as a service charge, attributable to additional services and allocated overhead costs that otherwise would not have been incurred
  3. A third alternative that is suggested is for the bank to stipulate a condition in the contract that in the event of payment default of a single installment that is due, the remaining installments will become due immediately. However, this alternative may cause undesirable hardships for the customer and has a lesser acceptance among bankers.
  4. A fourth alternative to minimize default risk is for the bank to seek a security from its customer either in the form of a mortgage or in the form of a lien or a charge on any of his/her existing assets. The bank can also ask the customer to furnish a guarantee from a third party. In case of default in the payment of price at the due date, the bank may have recourse to the guarantor, who will be liable to pay the amount guaranteed by him.

The bank may also ask its customer to sign a promissory note or a bill of exchange.

5. Yet another alternative is to impose only non-financial penalty such as imprisonment, or defamation. Solvent defaulter should be dealt with punishment, rather than compensation. this

Rescheduling of Payments

- At times, rescheduling of installments is seen as a way out in the face of default.
- In conventional banking, loan rescheduling is accompanied by additional interest charge for the timing differences.
- *Murabaha* does not allow such rescheduling as no additional amount can be charged for the same. The amount of the *murabaha* price remains unchanged.
- Some banks attempt to circumvent this by changing the unit of currency. This attempt is not permissible.

Rebate on Early Payment

- Conventional financial system grants the borrower a discount or rebate if the customer decides to pay earlier than the scheduled time.
- Regarding Islamic financial system, majority view is that a rebate given for early payment, if stipulated in the contract, is not permissible.
- However, if it is given voluntarily, it is allowed. The rate of discount must not be pre-specified in the *murabaha* contract as a condition. It is not a right that the debtor can claim
- However, most of present day Islamic banks do provide for a rebate in case of early repayment. As a result, the customer will benefit from not paying the profit for the remaining period.

Securitization of Murabaha Debt

- ✧ The obligation of the debtor to pay is a monetary indebtedness and hence is money. Money can only be exchanged with money at par.
- ✧ Money cannot be sold or purchased at a lower or higher price. Thus the *murabaha* debt cannot be made into a negotiable instrument

MISUSE OF MURABAHA FINANCING

- ✧ After explaining the concept of *murabaha* and its relevant issues, it is crucial to highlight some basic mistakes often committed by financial institutions in the practice and implementation of the concept.
    1. Selling of the item to the customer before the item is actually acquired by the Islamic institution from the supplier. This mistake is committed in transactions where all the documents of *murabaha* are signed at one time without taking into account the various stages of the *murabaha*.
    2. *Murabaha* can only be used where there is an item intended to be purchased by the customer. As a result, using *murabaha* for financing the overhead expenses of a firm - such as paying salaries or electricity bills - is prohibited under *Shari'a* law. It is the Islamic bank's duty to make sure that the customer really intends to purchase an item, which may then be subject to *murabaha*. Authorities providing the service to the customer must obtain this assurance.
    3. Islamic financial institutions might implement *murabaha* financing on items that are already purchased by the customers from a third party. Once the customer himself purchases the item, it cannot be purchased again by the bank from the same supplier.

       If the bank purchases it from the customer himself, it is a buy-back technique, which is not allowed according to *Shari'a*.

       In fact, m*urabaha* can only take place on commodities not yet purchased by the customer.

STRUCTURES OF MURABAHA

- There are three different structures of *Murabaha*:

1. **Two – Party Structure**
    - The simplest possible structure emerges when the transaction involves two parties only - the buyer and the seller. The seller, may be a bank, sells the item to the buyer, its customer, on a deferred payment basis.
    - From *Shari'a* point of view, such a structure is the most ideal one. Its profits are fully justified by the risk it assumes as a seller and there is no suspicion of riba.
    - This structure has recently been used in car financing products. The bank in this case claims to have its own car show rooms from where its customers may purchase cars on a deferred payment basis.

2. **Three – Party Structure**
    - In most cases however, the mechanism involves three parties - the seller or supplier, the bank and the customer.
    - In this case, the bank will buy the good from the original seller; then will resell the good to the customer.
    - Hence, there are two distinct sale contracts that occur at different points of time. The first contract is between the seller and the bank and second contract is between the bank and its customer.

3. **Three – Party Structure with Customer as Agent**
    - Another possible scenario exists when the bank would not like to directly deal with the seller in connection with the first purchase/sale of the item.
    - In this case, the bank will appoint the customer as its agent who would deal with the seller as far as the first purchase/sale of the item is concerned. Once the bank purchased the commodity, the

agency agreement with the customer is cancelled and the customer now will purchase the good from the bank.

- This mechanism, where the customer acts as the agent of the bank for the first sale transaction, may be ideal when the customer requires specialized equipment and is better informed than the bank about the product(s) and source(s) of supply.
- This arrangement may also be desirable for recurring trade-financing transactions or working capital financing.

✧ It is interesting to note in the structure how the relationship between the bank and its customer changes from one phase to another. In the first phase, the relationship between them is that of a promisee and promisor; it then changes into a principal-agent relationship; in the third phase, it is between a seller and a buyer; and finally when the sale is on a deferred payment basis, it is a creditor-debtor relationship. Therefore, it is important that at each stage, their roles, rights, obligations and their implications are distinctly understood.

SIMPLE MURABAHA PROCESS

✧ The simple three-party financing process may be presented as follows. The other two structures are the same with necessary modifications.

1. Customer identifies and approaches Seller or supplier of the item that he wishes to purchase which may be land, building, machinery, etc., and collects all relevant information;
2. Customer approaches the bank for *murabaha* financing for the item he wishes to purchase. He will present full description and detailed specification including the source of supply.
3. The bank will run a credit evaluation, the same way this is done in a conventional bank.
4. If the customer request is acceptable the bank offers to purchase the item and sell it to the customer at a mutually agreed marked-up price.

5. This markup price will be quoted, most probably as a per annum flat rate based on the total cost of acquiring the item by the bank, which needs price, and all related expenses.
6. Both the customer and the bank know beforehand the price of the item and the markup, which the bank is going to charge. The marked-up price specified in the *murabaha* agreement can not be changed.
7. If the profit margin and terms of the *murabaha* is accepted then the customer will be asked to sign a pledge agreement committing to buy the item once it is under the possession of the bank. If the bank owns it within the agreed-upon time with exactly the required specification, then honoring this pledge is obligatory on the customer. It means that, if the customer fails to honor his commitment he will be liable for any loss that may accrue to the bank due to such failure. The agreement specifies, among other things, the amount due from the customer, and the method and period of its repayment. The customer can repay either in lump sum at an agreed date, or in installments over a mutually agreed period.
8. As part of the *murabaha* transaction, the customer will be asked to present some securities to the bank at the time of signing the pledge. These securities can be in the form of cash or in any other liquid asset, equivalent to about 5% to 10% of the deal. This is called, in Islamic banking Jargon, (or Seriousness Margin) i.e. an evidence that the customer is serious. This will be used to compensate the bank in case the latter have failed to honor his commitment to purchase. It is to be noted that this is not a down-payment, because the sale contract is yet to be concluded. In *Shari'a,* no sale is to be made unless the seller actually has the items to be sold under his custody.
9. The bank makes payment of base price to the seller. Seller transfers ownership of item to the bank;

10. Once the good is ready, the customer will be asked to sign the contract and receive the item.
11. After receiving the item, the customer becomes the legal owner of it, and a debtor to the bank for the amount of the marked-up price.
12. The customer pays marked-up price in full or in parts over future (known) time period(s).

AREAS OF APPLICATIONS

- *Murabaha* is presently used to finance purchase of fixed assets such as, land, building, machinery and equipments, automobiles, computers, furniture and the like; and also suitable for financing purchase of personal assets and consumer durables, such as, PCs, cars, houses etc.

Working Capital Financing:

- *Murabaha* is suitable for manufacturers who need working capital on a relatively short-term basis to finance acquisition of raw materials and consumables or for traders who need working capital for financing acquisition of merchandise.
- The Islamic bank buys certain commodities requested by customers who by presenting trade instruments such as purchase orders and other attendant proof of trading transactions establish the existence of a ready market for the goods requested.
- The eventual repayment of the financing exposure includes a prearranged markup for the Islamic bank. Such working capital financing caters to domestic transactions only.
- Working capital financing under *murabaha* principle is provided in the following manner:
  - The customer requests the bank to provide financing for his working capital requirements by purchasing stocks and inventories, spares and replacements, raw materials or semi finished products under the

principle *murabaha*.

- The bank purchases or appoints the customer as its agent to purchase the required goods utilizing its own funds.
- The bank subsequently sells the goods to the customer at an agreed price on a mark-up basis.
- The bank allows the customer to settle the sale price on a deferred term as may be agreed upon between the parties.

Working Capital Letter of Credit (LC):

- ✧ This mode of trade financing is provided fully in the form of an LC instrument negotiated from foreign countries as requested by an eligible customer. The total importation cost plus a pre-arranged mark-up is then repaid to the Islamic bank upon resale of the imported item. The LC under *murabaha* is provided as follows:
  - The customer informs the bank of his LC requirements and requests the bank to purchase/import the goods indicating thereby that he would purchase the goods from the bank on their arrival under the principle of *murabaha*.
  - The bank establishes the LC and pays the proceeds to the negotiating bank using its own funds.
  - The bank sells the goods to the customer at a price comprising its cost and profit margin for settlement by cash or on a deferred basis in accordance with *murabaha* principle.

In principle, *murabaha* means mark-up sale. It is a sale contract in which the object of sale is sold at a price equivalent to the cost price and profit margin. If the cost price = $500 and the profit margin = $200, the *murabaha* price = $700. However *murabaha* today has been associated with credit sale. This is not totally accurate. There are two types of murabaha, namely:

Cash *murabaha* i.e. a sale contract where the seller sells a commodity with a price equal to the cost price and a profit margin. The purchase is settled in cash.

Credit *murabaha* i.e. a credit sale with purchases settled by installment payments. The price is equal to cash *murabaha* prices but a premium is added over the profit margin to reflect time value of money. In Malaysia, short-term credit murabaha is simply called murabaha with payment payable lumpsum. A long-term credit *murabaha* is known as *al-bai-bithaman ajil (BBA)*. BBA is also known as *bay'muajjal* and *murabaha* in Pakistan and the Middle-east countries